87/6

87 T.C. 1213-1514

UNITED STATES TAX COURT

REPORTS

Vol. 87 **No. 6**

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December 1, 1986, to
December 31, 1986

UNITED STATES TAX COURT

WASHINGTON, D.C.

AMENDMENTS TO THE TAX COURT
RULES OF PRACTICE AND PROCEDURE
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TABLE OF CASES REPORTED IN VOL. 87 T.C. IS
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JU 11.7/a 2:

JUDGES OF THE UNITED STATES TAX COURT

Chief Judge

Samuel B. Sterrett

Judges

Charles R. Simpson
Herbert L. Chabot
Arthur L. Nims III
Edna G. Parker
Meade Whitaker
Jules G. Körner III
Perry Shields
Lapsley W. Hamblen, Jr.
Mary Ann Cohen

Charles E. Clapp II
Stephen J. Swift
Julian I. Jacobs
Joel Gerber
Lawrence A. Wright
Carolyn Miller Parr
B. John Williams, Jr.
Thomas B. Wells
______ ______ (VACANCY)

Senior judges recalled to perform judicial duties under the provisions of section 7447 of the Internal Revenue Code of 1954:

Arnold Raum
William M. Drennen
Irene F. Scott
Theodore Tannenwald, Jr.
C. Moxley Featherston

Darrell D. Wiles
William M. Fay
Richard C. Wilbur
William A. Goffe

Special Trial Judges

John J. Pajak, *Chief Special Trial Judge*

James M. Gussis
Francis J. Cantrel
Daniel J. Dinan
Marvin F. Peterson
Lee M. Galloway
Helen A. Buckley
Peter J. Panuthos

Joan Seitz Pate
Hu S. Vandervort
D. Irvin Couvillion
Norman H. Wolfe
Stanley J. Goldberg
Carleton D. Powell
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Paul Nejelski, *Court Administrator*

Mary T. Pittman, *Reporter of Decisions*

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AMENDMENTS

to

RULES OF PRACTICE AND PROCEDURE

of the

UNITED STATES TAX COURT

The Rules of Practice and Procedure of the United States Tax Court are amended by adding Rule 193, and by amending Rules 11, 34, and 200.

The Notes accompanying these amendments were prepared by the Rules Committee and are included herein for the convenience of the Bar. They are not officially part of the Rules and are not included in the printed publication prepared for general distribution.

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TITLE II

THE COURT

RULE 11. PAYMENTS TO COURT

***All payments to the Court for fees or charges of the Court shall be made either in cash or by check, money order, or other draft made payable to the order of "Clerk. United States Tax Court," and shall be mailed or delivered to the Clerk of the Court at Washington, D.C. 20217. For particular payments, see Rules 12(c) (copies of Court records), 20(b) (filing of petition), 175(a)(2) (small tax cases), 200(e) (application to practice before Court), and 200(i) (periodic registration fee).**

Note

The Rule has been amended to include a cross reference to Rule 200(i).

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*The amendment is effective as of February 6, 1987.

TITLE IV

PLEADINGS

RULE 34. PETITION

*(a) **General:** (1) *Deficiency or Liability Actions:* The petition with respect to a notice of deficiency or a notice of liability shall be substantially in accordance with Form 1 shown in Appendix I, and shall comply with the requirements of these Rules relating to pleadings. Ordinarily, a separate petition shall be filed with respect to each notice of deficiency or each notice of liability. However, a single petition may be filed seeking a redetermination with respect to all notices of deficiency or liability directed to one person alone or to him and one or more other persons, except that the Court may require a severance and a separate case to be maintained with respect to one or more of such notices. Where the notice of deficiency or liability is directed to more than one person, each such person desiring to contest it shall file a petition on his own behalf, either separately or jointly with any such other person, and each such person must satisfy all the requirements of this Rule with respect to himself in order for the petition to be treated as filed by or for him. The petition shall be complete, so as to enable ascertainment of the issues intended to be presented. No telegram, cablegram, radiogram, telephone call, electronically transmitted copy, or similar communication will be recognized as a petition. Failure of the petition to satisfy applicable requirements may be ground for dismissal of the case. As to the joinder of parties, see Rule 61; and as to the effect of misjoinder of parties, see Rule 62. For the circumstances under which a timely mailed petition will be treated as having been timely filed, see Code Section 7502.

Note

Subpar. (1) of par. (a) of Rule 34 has been amended to reflect the Court's holding in *Blum v. Commissioner*, 86 T.C. 1128 (1986). In *Blum* the Court held that an electronically transmitted copy of a petition is a communication similar to a telegram, cablegram, radiogram, or telephone call and will not be recognized as a petition.

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*The amendment is effective as of May 29, 1986.

Subpar. (1) has also been amended to include a reference to the timely mailing/timely filing provisions of Code Section 7502.

The amendments are effective May 29, 1986, the date on which the Court's report in *Blum v. Commissioner, supra*, was filed.

TITLE XIX

APPEALS

*RULE 193. APPEALS FROM INTERLOCUTORY ORDERS

(a) General: For the purpose of seeking the review of any order of the Tax Court which is not otherwise immediately appealable, a party may request the Court to include, or the Court on its own motion may include, a statement in such order that a controlling question of law is involved with respect to which there is a substantial ground for difference of opinion and that an immediate appeal from that order may materially advance the ultimate termination of the litigation. Any such request by a party shall be made by motion which shall set forth with particularity the grounds therefor and note whether there is any objection thereto. Any order by a Judge or Special Trial Judge of the Tax Court which includes the above statement shall be entered upon the records of the Court and served forthwith by the Clerk. See Code Section 7482(a)(2). For appeals from interlocutory orders generally, see Rules 5 and 14 of the Federal Rules of Appellate Procedure.

(b) Venue: For the circuit of the Court of Appeals to which an appeal from an interlocutory order may be taken, see Code Section 7482(a)(2)(B) and 7482(b).

(c) Stay of Proceedings: Unless so ordered, proceedings in the Tax Court shall not be stayed by virtue of any interlocutory order that is or may be the subject of an appeal. See Code Section 7482(a)(2)(A).

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*Rule 193 is effective as to interlocutory orders entered after October 22, 1986.

Note

This is a new Rule based upon Code Section 7482(a)(2), which was added by section 1558(a) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2757. Section 7482(a)(2) expressly authorizes the United States Courts of Appeals to permit, in their discretion, an appeal to be taken from certain interlocutory orders of this Court. See *Shapiro v. Commissioner*, 632 F.2d 170 (2d Cir. 1980), for a discussion of prior law.

Par. (a) of Rule 193 contemplates that a party seeking review of an order which is not otherwise appealable must satisfy a Judge or Special Trial Judge of the Tax Court (1) that a controlling issue of law is involved, (2) that with respect to the controlling issue of law, there is a substantial ground for difference of opinion, and (3) that an immediate appeal from that order may materially advance the ultimate termination of the litigation. A party seeking review shall proceed by motion, which may be filed before or after the interlocutory order with respect to which appeal is or may be sought. The provisions of Rule 50 should be consulted for general requirements pertaining to motions.

Par. (b) of Rule 193 refers the parties to the statutory provisions governing venue on appeal from an interlocutory order of this Court.

Par. (c) of Rule 193 provides that proceedings in this Court shall not be automatically stayed by virtue of any interlocutory order that is or may be the subject of an appeal. A party who wants to stay proceedings should file an appropriate motion.

Rule 193 applies to interlocutory orders entered after October 22, 1986.

TITLE XX

PRACTICE BEFORE THE COURT

RULE 200. ADMISSION TO PRACTICE AND PERIODIC REGISTRATION FEE

(a) - (h) [Not changed]

*(i) **Periodic Registration Fee:** (1) Each practitioner admitted to practice before the Court shall pay a periodic

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*The amendment is effective February 6, 1987.

registration fee. The frequency and amount of such fee shall be determined by the Court, except that such amount shall not exceed $30 per calendar year. The Clerk of the Court shall maintain an Ineligible List containing the names of all practitioners failing to comply with the provisions of this Rule. No practitioner shall be permitted to commence a case in the Court or enter an appearance in a pending case while on the Ineligible List. The name of any practitioner appearing on the Ineligible List shall not be removed from the List until the currently due registration fee has been paid and all arrearages have been made current. The periodic registration fee must be paid by all persons admitted to practice before the Court, whether or not engaged in private practice. As to forms of payment, see Rule 11.

(2) The fees described in Rule 200(i)(1) shall be used by the Court to employ independent counsel to pursue disciplinary matters.

Note

A new par. (i) has been added to Rule 200, based upon Code Section 7475, which was added by section 1553 of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2754. Section 7475 authorizes the Court to impose a periodic registration fee on practitioners admitted to practice before it. The Court is to establish the level of the fee and the frequency of its collection, but the fee may not exceed $30 per year. These funds are available to the Court to pay independent counsel engaged by the Court to pursue disciplinary matters.

Under the Rule the Clerk of the Court will maintain an Ineligible List containing the names of practitioners failing to comply with the provisions of the Rule. No practitioner whose periodic registration fee payments are not current will be permitted to commence a case in the Court or enter an appearance in a pending case. All persons admitted to practice before the Court are required to pay the periodic registration fee, whether or not engaged in private practice.

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Charitable—Universal Life Church—Fraud Additions for Check-Swapping Schemes.—Where petitioners claimed charitable contribution deductions for payments made to various Universal Life Churches and to fund established and maintained by Universal Life Church, Inc., of Modesto, California; and all such payments were repaid to petitioners or to their own Universal Life Church, Court determined (1) under sec. 170(a), petitioners were not entitled to a charitable contribution deduction, since no actual contributions were made (*Davis v. Commissioner*, 81 T.C. 806, affd. without published opinion 767 F.2d 931 (9th Cir); *Glynn v. Commissioner*, 76 T.C. 116, 121-122, affd. without published opinion 676 F.2d 682 (lst Cir.); *Sims v. Commissioner*, 72 T.C. 996, 1008-1009); and (2) petitioners were liable for additions to tax for fraud under sec. 6653(b), since elaborate check-swapping schemes employed by petitioners provided sufficient evidence to carry Commissioner's burden of proof. ***Wedvik v. Commissioner*** 1458

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under distribution agreements, X and Y transferred to W all their rights, except copyrights, in such movies; and A and B reported their pro rata shares of partnership losses, Court determined (1) partnerships did not acquire a depreciable interest in motion pictures, since under agreements, they purchased, in substance, only a contractual right to payments contingent on success of motion pictures, and transactions resulted in W's retaining rights and liabilities commonly associated with ownership; and (2) partnerships were entitled to depreciate their bases in such contract rights. ***Durkin v. Commissioner*** 1329

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Reform Act of 1984, as amended by Tax Reform Act of 1986, petitioner's loss was allowable without regard to existence of profit motive and without regard to whether it was incurred as part of his regular trading activities, and (3) gain was properly long-term capital gain because sec. 1233 is not applicable to physical commodities. *King v. Commissioner* 1213

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OF THE

UNITED STATES TAX COURT

MARLOWE KING, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 15350-84. Filed December 2, 1986.

Petitioner incurred loss on dispositions in 1980 of positions constituting part of a gold commodity futures straddle. During 1980, petitioner also realized a gain on the sale of gold bars. By notice of deficiency, respondent disallowed the loss and recharacterized the gain as short-term capital gain. Petitioner filed a motion for partial summary judgment with respect to both of these issues. *Held*, respondent has not shown that there is a genuine issue of sham with respect to

the loss. *Held, further*, respondent has not shown that there is a genuine issue of fact with respect to profit motive or petitioner's regular trading activities because, as a commodities dealer, in light of sec. 108 of the Tax Reform Act of 1984, as amended by the Tax Reform Act of 1986, petitioner's loss is allowable without regard to the existence of a profit motive and without regard to whether it was incurred as part of his regular trading activities. *Held, further*, sec. 1233, I.R.C. 1954, is not applicable to physical commodities and, therefore, petitioner's gain is properly long-term capital gain. *Held, further*, petitioner's motion for partial summary judgment is granted.

Stephen Lewis, *Bradford Ferguson*, *Frederick Hickman*, *Peter Freeman*, and *Michael Clark*, for the petitioner.

Alan M. Jacobson, for the respondent.

OPINION

CLAPP, *Judge*: This case is before the Court on petitioner's motion for partial summary judgment filed August 29, 1986, pursuant to Rule 121.[1]

Respondent determined deficiencies in petitioner's Federal income taxes as follows:

Year	*Deficiency*
1979	$19,989.34
1980	1,525,852.76

The issues to which this motion relates are (1) whether petitioner's loss on the dispositions in 1980 of positions constituting part of a gold commodity futures straddle are deductible in 1980, and (2) whether gain on the sale of gold bars in 1980 qualifies as long-term capital gain.

Petitioner has moved for summary judgment as to both of these issues, alleging that there are no genuine issues of fact and that a holding in favor of petitioner is appropriate. Rule 121(a) provides, in part, that either party may move for a summary adjudication in his favor upon all or any part of the legal issues in controversy. Rule 121(d) provides, in part:

> Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and

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[1] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure.

> shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or filed therewith. The Court may permit affidavits to be supplemented or opposed by answers to interrogatories, depositions, further affidavits, or other acceptable materials, to the extent that other applicable conditions in these Rules are satisfied for utilizing such procedures.

Rule 121(d) further provides that:

> When a motion for summary judgment is made and supported as provided in this Rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this Rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, a decision, if appropriate, may be entered against him.

Petitioner has provided us with a sworn affidavit describing the transactions in question. Respondent has conceded some of the facts contained in petitioner's affidavit. For purposes of clarity, we will deal separately with each of the issues upon which petitioner requests that we grant summary judgment.

Straddle Losses

Petitioner is a registered member of the Chicago Mercantile Exchange (CME) and its division, the International Monetary Market (IMM). The CME is a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission. From 1950 to the present, petitioner has actively and regularly traded commodities and regulated futures contracts and has derived most of his income from such trading.

From June 23, 1980, through March 11, 1981, petitioner established and disposed of positions in gold futures contracts. These positions were held in the form of straddles,[2] and are set forth in attached Appendix A. All of petitioner's 1980-81 gold straddle positions were disposed of by March 11, 1981. The trades in dispute are as follows:

> 1. The purchase on July 2, 1980, of 66 June 1981 gold futures contracts which offset 66 short June 1981 gold contracts and which generated a loss of $550,900.

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[2] A description of commodities future trading by the use of straddles can be found in *Miller v. Commissioner*, 84 T.C. 827, 828-830 (1985), on appeal (10th Cir., Nov. 20, 1985); and *Smith v. Commissioner*, 78 T.C. 350, 354-357 (1982).

2. The purchase on July 3, 1980, of 30 December 1980 gold contracts which offset 30 short December 1980 gold contracts and which resulted in a profit of $16,150, and the purchase on July 3, 1980, of 30 December 1981 gold contracts which offset 30 short December 1981 gold contracts and which generated a profit of $17,100.

3. The purchase on July 14, 1980, of 60 June 1981 gold contracts which offset 60 short June 1981 gold contracts and which generated a loss of $372,000.

4. The purchase on September 10, 1980, of 33 December 1980 gold contracts which offset 33 short December 1980 gold contracts and the purchase on September 10, 1980 of 33 December 1981 gold contracts which offset 33 short December 1981 gold contracts, which purchases generated a combined loss of $306,390.

5. The sale on December 29, 1980, of 80 March 1981 gold contracts, which offset 80 long March 1981 gold contracts and which generated a loss of $256,860.

On his Federal income tax return for 1980, petitioner deducted $1,452,900 in short-term capital losses from the above gold straddle transactions.

In his statutory notice of deficiency, respondent disallowed the claimed losses for 1980. The reasons stated for the disallowance of the losses were as follows:

> The transactions at issue were either shams or devoid of the substance necessary for recognition for federal income tax purposes. Recognition of the claimed loss would distort the economic reality of the entire transaction. No genuine loss occurred, the alleged loss was but one step in a series of integrated transactions, and the entire transaction lacked economic reality.

In his response to petitioner's motion for summary judgment, respondent sets out three arguments for summary judgment being inappropriate with respect to petitioner's claimed losses:

1. Petitioner has failed to address the threshold issue of whether the transactions at issue were shams;
2. Petitioner has failed to show that he is entitled to the presumption under section 108(b) of the Tax Reform Act of 1984 and Temp. Treas. Reg. Sec. 1.165-13T; and
3. Even if petitioner were entitled to the presumption, a trial would nevertheless be required to resolve the "for profit" issue which is inherently factual.

By sworn affidavit, petitioner provided us with detailed information concerning his background, his CME and IMM trading activities, and his trading strategies, as well as general information on the trading of gold futures contracts by the use of straddles. Clearly, petitioner's description of his trading activity fully addresses any sham allegations concerning whether the trades occurred. Further, in considering respondent's allegation of sham, we cannot fail to note the regulated nature of the exchange upon which these trades were made.[3] Respondent, however, has failed to allege any facts to support his general allegation of sham. Our first issue for decision is therefore whether, under such circumstances, respondent may use a bare assertion of sham as a defense to a motion for summary judgment.

Rule 121(d) states that when a motion for summary judgment has been made and supported as required by our Rules, "an adverse party may not rest upon the mere allegations or denials of his pleadings" and that such a party must "set forth *specific* facts showing that there is a genuine issue for trial." (Emphasis added.) Although petitioner has included in his affidavit detailed facts supporting the bona fide nature of his trading in gold contracts, respondent failed to allege or support any facts tending to demonstrate that the transactions in question were shams. Under these circumstances, respondent has not shown that there is a genuine issue of sham for trial and, therefore, has not established an adequate defense to petitioner's motion for summary judgment. To hold otherwise would be to render the requirements of Rule 121(d) meaningless.

The second and third arguments which respondent has made against the granting of petitioner's motion for summary judgment with respect to the losses are both impacted by the Tax Reform Act of 1986. Section 108 of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630) (Section 108) provided, in part:

> SEC. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.
>
> (a) GENERAL RULE.—For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions—
>
> (1) which are entered into before 1982 and form part of a straddle, and

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[3] See *Perlin v. Commissioner*, 86 T.C. 388 (1986); cf. *Glass v. Commissioner*, 87 T.C. 1087 (1986).

(2) to which the amendments made by title V of such Act do not apply,

any loss from such disposition shall be allowed for the taxable year of the disposition if such position is part of a transaction entered into for profit.

(b) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT.—For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

Section 1808(d) of the Tax Reform Act of 1986 made technical corrections to section 108, in part, as follows:

(d) SECTION 108.—Section 108 of the Tax Reform Act of 1984 is amended—

(1) by striking out "if such position is part of a transaction entered into for profit" and inserting in lieu thereof "if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business,"

(2) by striking out subsection (b) and inserting in lieu thereof the following:

"(b) LOSS INCURRED IN A TRADE OR BUSINESS.—For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business."

Respondent's remaining arguments against petitioner's motion for summary judgment are that, (1) petitioner must establish at trial that he regularly traded in gold in order for the provisions of section 108(b) to apply, and (2) even if petitioner was a dealer in gold, he would only be rebuttably presumed to have incurred the losses in a transaction entered into for profit, and at trial, it must be determined whether such a profit motive actually existed. Respondent has conceded that petitioner was a dealer in commodities within the meaning of section 108(f). We believe that the technical corrections to section 108 make it clear that these arguments are not valid defenses to petitioner's motion for summary judgment.

The amendments to section 108 now provide that any loss incurred by a commodities dealer in the trading of commodities is deductible without regard to the existence of a profit motive.[4] This is a per se rule and no longer a rebuttable presumption. As respondent has conceded that petitioner is a commodities dealer, the provisions of section 108 have been satisfied.[5]

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[4] The legislative history of the provision states, in part, that "The subsection (b) treatment is only for purposes of subsection (a), and no inference should be drawn that a loss is incurred in a trade or business for any other purpose, such as for purposes of section 162, 163(d) or 172." H. Rept. 99-426, at 911 (1985).

Respondent nevertheless argues that petitioner must establish that the transactions in question were part of his regular trading activities in order for the provisions of section 108(b) to be applicable. See sec. 1.165-13T, Q & A-6, Temporary Income Tax Regs., 49 Fed. Reg. 33445 (Aug. 23, 1984).[6] The Conference Committee statement of managers,[7] however, states with respect to the amendments to section 108(b) that,

> If a person qualifies as a commodities dealer, the subsection (b) treatment applies with respect to any position disposed of by such person. It would, for example, apply without regard to whether the position was in a commodity regularly traded by the person, whether it was traded on an exchange on which the dealer was a member, or whether an identical position was re-established on the same trading day or subsequently. * * * [Conf. Rept. 99-841, at II-845.]

The Conference report makes clear that the applicability of subsection (b) treatment does not turn on whether the transactions in question were part of petitioner's regular trading activities. Therefore, section 108(b) is applicable to the transactions in question and petitioner's loss on his straddle transactions in 1980 is allowable.

Petitioner has fully supported his claim that no genuine issue for trial exists with respect to his 1980 straddle losses. Respondent has failed to allege any specific facts which would constitute genuine issues for trial. Accordingly, petitioner's motion for summary judgment will be granted with respect to this issue.[8]

Gains From the Sale of Gold

In satisfaction of 100 long gold futures contracts that called for delivery in December 1978, petitioner received warehouse receipts representing 10,000 ounces of gold on December 1, 1978. Petitioner paid a $1,929,165.17 delivery price on December 4, 1978.

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[5] Respondent has not argued that the requirements of sec. 108(a)(1) and (2) are not satisfied. The record clearly shows that they have been satisfied.

[6] See also *Perlin v. Commissioner*, *supra* at 422-423.

[7] When interpreting a statute, the Court may look to legislative history for interpretive assistance. *Perlin v. Commissioner*, *supra* at 419; *Miller v. Commissioner*, *supra* at 838 n. 20.

[8] The per se rule of sec. 108(b) would not preclude us from finding for respondent in another case. The legislative history of the provision makes clear that it was not intended to apply "where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." H. Rept. 99-426, at 911 (1985). See also *DeMartino v. Commissioner*, T.C. Memo. 1986-263.

From October 4, 1978, through May 5, 1980, petitioner established and disposed of straddle positions in gold futures contracts as shown in Appendix B. Throughout the period from December 1, 1978, through May 1, 1980, petitioner continually bought and sold gold futures contracts but generally maintained a balanced position taking into account the delivered gold commodity.

Petitioner's position on May 1, 1980, was short 100 May 1980 gold futures contracts and long the delivered gold. On May 2, 1980, petitioner delivered the warehouse receipts to the Chicago Mercantile Exchange Clearing House in satisfaction of the petitioner's delivery obligations under the 100 short May 1980 gold contracts acquired on May 1, 1980. This delivery closed out his positions in the gold contracts. On petitioner's 1980 Federal income tax return he reported a $3,244,712 long-term capital gain from the May 2, 1980, delivery of the gold bars to close the May 1, 1980, short position.

Respondent determined in his notice of deficiency that this gain should be treated as short-term capital gain pursuant to section 1233(b).[9] Respondent maintains this position and objects to petitioner's motion for summary judgment as it relates to this issue.

Section 1233(b) provides, in relevant part:

> SEC. 1233(b). Short-Term Gains and Holding Periods.—If gain or loss from a short sale is considered as gain or loss from the sale or exchange of a capital asset under subsection (a) and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 1 year (determined without regard to the effect, under paragraph (2) of this subsection, of such short sale on the holding period), or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof—
>
> (1) any gain on the closing of such short sale shall be considered as a gain on the sale or exchange of a capital asset held for not more than 1 year (notwithstanding the period of time any property used to close such short sale has been held); * * *

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[9] Unless otherwise indicated, all section references are to the Internal Revenue Code as amended and in effect during the years in issue.

Respondent asserts that because petitioner maintained short positions in gold futures contracts which offset his position in the delivered gold throughout the time he held the delivered gold, section 1233(b) is applicable and provides that petitioner's gain is to be treated as short-term capital gain.

Petitioner asserts that the provisions of section 1233 are not applicable to this transaction because physical commodities, such as were used to close the short sale in this case, are not within the scope of the section. Section 1233(e)(2)(A) provides:

> SEC. 1233 (e). RULES FOR APPLICATION OF SECTION.—
>
> * * * * * *
>
> (2) For purposes of subsections (b) and (d)—
>
> (A) the term "property" includes only stocks and securities (including stocks and securities dealt with on a "when issued" basis), and commodity futures, which are capital assets in the hands of the taxpayer * * *

The parties agree that the commodity in this case, i.e., the gold, was a capital asset in the hands of petitioner, but disagree as to whether this definition of property can be read to include commodities, in addition to commodity futures.

We note initially that the use of the words "includes only" unambiguously restricts the application of the section to property which is enumerated in the provision. Respondent, nevertheless, argues that physical commodities should be found to be within the scope of the provision and that the legislative history of the predecessor of section 1233 supports such an interpretation. Assuming that an examination of the legislative history is appropriate in these circumstances, we find that it does not support respondent's interpretation of the provision.

The legislative history to which respondent directs our attention is the House Committee Report on the predecessor to section 1233. The report stated, in part:

> At the present time it is possible for an investor in stocks to realize a capital gain in less than 6 months and obtain long-term capital gain tax treatment on it by making a short sale which will assure his gain on his original investment, and then defer closing out the short sale until he has held his original stock investment for more than 6 months. * * *

> * * * * * * *
>
> Much the same device may be used by a taxpayer to avoid tax on l profits from speculation in commodity futures. This device is not use however, by businessmen who deal in commodity futures to offset regul business dealings in actual commodities, since they are not affected l the long-term and short-term capital gain provisions. * * *
>
> [H. Rept. 2319, 81st Cong., 2d Sess. (1950), 1950-2 C.B. 380, 421.]

Respondent asserts that the sale here in issue was of type which section 1233 was intended to cover and that thi is demonstrated by the above portion of the legislativ history. The cited language, however, read in conjunctio with the use of the phrase "includes only" in the legislatior seems more likely to be an explanation of why Congres chose not to include actual commodities within the scope c the provision. Congress was apparently of the belief tha actual commodities would only be dealt in by those wh were regularly in the business of dealing in commodit futures and who would not be affected by the capital gai provisions. At the very least, this language in the legislative history demonstrates Congress' awareness that actua commodities could be used to offset a short sale in the sam manner as commodity futures. Congress, nevertheless, di not choose to list commodities as a type of property t which section 1233(b) and (d) should apply.

We also take note of the provisions of section 1234, whicl deal with the sale or exchange of, or the failure to exercise an option to buy or sell property. This section defines th scope of the property to which it applies as follows:

> SEC. 1234(b). TREATMENT OF GRANTOR OF OPTION IN THE CASE OI STOCK, SECURITIES, OR COMMODITIES.—
>
> * * * * * * *
>
> (2) DEFINITIONS.—For purposes of this subsection—
>
> * * * * * * *
>
> (B) PROPERTY.—The term "property" means stocks and securitie (including stocks and securities dealt with on a "when issued" basis) *commodities, and commodity futures*. [Emphasis added.]

Here, Congress has likewise enumerated a list of types o properties which includes commodity futures. The designation of both commodities and commodity futures, however, tends to demonstrate that Congress does not consider the terms to be synonymous.

While respondent's policy argument as to why actual commodities should be treated as being within the scope of section 1233 may have some merit, we do not believe that the intended scope of the section encompasses actual commodities. As the application of section 1233 is the only basis respondent has put forward for treating petitioner's gain as short-term rather than long-term capital gain, we will grant petitioner's motion for partial summary judgment as to this issue as well.

To reflect the foregoing,

An appropriate order will be issued.

Reviewed by the Court.

STERRETT, SIMPSON, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, HAMBLEN, COHEN, SWIFT, JACOBS, GERBER, WRIGHT, PARR, WILLIAMS, and WELLS, *JJ.*, agree with this opinion.

SHIELDS, *J.*, did not participate in the consideration of this opinion.

Appendices to this opinion follow on pages 1224-1232.

APPENDIX A

GOLD STRADDLE—1980-1981

	CONTRACTS—LONG OR (SHORT) Dec. 1980	Mar. 1981	June 1981	Sept. 1981	Dec. 1981	Current balance long (short)	Realized gain (loss)	CUMULATIVE Realized gain (loss)	Unrealized gain (loss) in account	Net equity in account
1. 6/23/80										
Trade		75	(150)	75						
Position		75	(150)	75		150 (150)	...	...	($1,500)	($1,500)
2. 6/25/80										
Trade		6		...						
Position		81	(150)	75		156 (150)	...	...	(5,310)	(5,310)
3. 6/27/80										
Trade		6	...	...						
Position		87	(150)	75		162 (150)	...	...	22,730	22,730
4. 6/30/80										
Trade		(3)	...	...						
Position		84	(150)	75		159 (150)	($250)	($250)	16,440	16,190
5. 7/1/80										
Trade		...	(2)	...						
Position		84	(152)	75		159 (152)	...	(250)	37,920	37,670
6. 7/2/80										
Trade	(33)	...	66	...	(33)					
Position	(33)	84	(86)	75	(33)	159 (152)	(550,900)	(551,150)	579,950	28,800
7. 7/3/80										
Trade	30	...	(62)	...	30					
Position	(3)	84	(148)	75	(3)	159 (154)	33,250	(517,900)	552,790	34,890
8. 7/14/80										
Trade	(30)	...	60	...	(30)					
Position	(33)	84	(88)	75	(33)	159 (154)	(372,000)	(889,900)	907,840	17,940
9. 7/16/80										
Trade	...	...	(2)	...	...					
Position	(33)	84	[illegible]	[illegible]	[illegible]					

GOLD STRADDLE—1980-1981

(continued)

	CONTRACTS—LONG OR (SHORT)					Current balance long (short)	Realized gain (loss)	CUMULATIVE		
	Dec. 1980	Mar. 1981	June 1981	Sept. 1981	Dec. 1981			Realized gain (loss)	Unrealized gain (loss) in account	Net equity in account
10. 7/25/80										
Trade	...	(3)	...	...	...					
Position	(33)	81	(90)	75	(33)	159 (156)	$450	($889,450)	$902,680	$13,230
11. 8/13/80										
Trade	(20)	...	...	...	...					
Position	(35)	81	(90)	75	(33)	159 (158)	...	(889,450)	904,930	15,480
12. 8/21/80										
Trade	(2)	...	...	...	...					
Position	(37)	81	(90)	75	(33)	156 (160)	...	(889,450)	903,350	13,900
13. 8/25/80										
Trade	2	...	...	...	...					
Position	(35)	81	(90)	75	(33)	156 (158)	920	(888,530)	902,880	14,350
14. 9/2/80										
Trade	2	...	...	...	...					
Position	(33)	81	(90)	75	(33)	156 (156)	(6,340)	(894,870)	906,070	11,200
15. 9/10/80										
Trade	33	...	(66)	...	33					
Position	...	81	(156)	75	...	156 (156)	(306,390)	(1,201,260)	1,209,070	7,810
16. 12/29/80										
Trade	...	(80)	...	80	...					
Position	...	1	(156)	155	...	156 (156)	(256,860)	(1,458,120)	1,459,780	1,660
17. 1/5/81										
Trade	...	(1)	...	...	...					
Position	...	...	(156)	155	...	155 (156)	(6,290)	(1,464,410)	1,461,780	(2,630)
18. 1/4/81										
Trade	...	...	1	...	...					
Position	...	...	(155)	155	...	155 (155)	5,850	(1,458,560)	1,441,030	(17,530)

GOLD STRADDLE—1980-1981
(continued)

	Contracts—long or (short)							Cumulative		
	Dec. 1980	Mar. 1981	June 1981	Sept. 1981	Dec. 1981	Current balance long (short)	Realized gain (loss)	Realized gain (loss)	Unrealized gain (loss) in account	Net equity in account
19. 2/5/81										
Trade	---	(1)	---	---	---					
Position	---	(1)	(155)	.5	---	155 (156)	---	($1,458,560)	$1,385,690	($72,870)
20. 2/13/81										
Trade	---	1	---	---	---					
Position	---	---	(155)	155	---	155 (155)	(370)	(1,458,930)	1,394,530	(64,400)
21. 2/24/81										
Trade	---	(1)	---	---	---					
Position	---	(1)	155	(155)	---	155 (156)	---	(1,458,930)	1,400,280	(58,650)
22. 2/26/81										
Trade		1	---	---	---					
Position		---	155	(155)	---	155 (155)	720	(1,458,210)	1,391,430	(66,780)
23. 3/4/81										
Trade		---	---	---	(1)					
Position		---	155	(155)	(1)	155 (156)	---	(1,458,210)	1,349,741	(108,470)
24. 3/6/81										
Trade		---	---	---	1					
Position		---	155	(155)	---	155 (155)	(600)	(1,458,810)	1,357,330	(101,480)
25. 3/11/81										
Trade		---	(155)	155	---					
Position		---	---	---	---	---	1,355,780	(103,030)	---	---

APPENDIX B

GOLD CASH AND CARRY STRADDLE—1978-1980

	Contracts—long or (short)									
	Dec. 1978	Mar. 1979	June 1979	Sept. 1979	Dec. 1979	Mar. 1980	Physical gold	Current balance long (short)	Realized gain (loss) per return	Cumulative realized gain (loss) per return
1. 10/4/78										
Position	3							3 ---	---	---
2. 10/6/78										
Trade	---	2								
Position	3	2						5 ---	---	---
3. 10/19/78										
Trade	---	3								
Position	3	5						8 ---	---	---
4. 10/26/78										
Trade	(2)	2								
Position	---	7						8 ---	$2,840	$2,840
5. 10/27/78										
Trade	(1)	---								
Position	---	7						7 ---	1,490	4,330
6. 10/31/78										
Trade	---	---	(7)							
Position	---	7	(7)					7 7	---	4,330
7. 11/3/78										
Trade	---	7/(7)	---							
Position	---	7	(7)					7 7	(9,600)	(5,270)
8. 11/13/78										
Trade	100	(100)	---							
Position	100	(93)	(7)					100 (100)	(3,430)	(8,700)
9. 11/17/78										
Trade	---	---	150	(300)	(150)					
Position	100	(93)	143	(300)	150			393 (393)	32,720	24,020

GOLD CASH AND CARRY STRADDLE—1978-1980
(continued)

	Contracts—long or (short)									
	Dec. 1978	Mar. 1979	June 1979	Sept. 1979	Dec. 1979	Mar. 1980	Physical gold	Current balance long (short)	Realized gain (loss) per return	Cumulative realized gain (loss) per return
10. 12/1/78										
Trade	Deliv.	---	---	---	---	---	100			
Position	---	(93)	143	(300)	150	---	100	393 (393)	($182,000)	($157,980)
11. 12/11/78										
Trade		(150)	---	300	---	(150)	---			
Position		(243)	143	---	150	(150)	100	393 (393)	(255,000)	(412,980)
12. 12/27/78										
Trade		36/(36)	---	---	---	---	---			
Position		(243)	143	---	150	(150)	100	393 (393)	(52,920)	(465,900)
13. 12/28/78										
Trade		164/(14)	---	(150)	---	---	---			
Position		(93)	143	(150)	150	(150)	100	393 (393)	(233,860)	(699,760)
14. 12/29/78										
Trade		---	5	---	---	---	---			
Position		(93)	148	(150)	150	(150)	100	398 (393)	---	(699,760)
15. 1/2/79										
Trade		---	(5)	---	---	---	---			
Position		(93)	143	(150)	150	(150)	100	393 (393)	(2,050)	(701,810)
16. 1/4/79										
Trade		---	---	---	2	---	---			
Position		(93)	143	(150)	152	(150)	100	395 (393)	---	(701,810)
17. 1/10/79										
Trade		---	---	---	2	---	---			
Position		93	143	(150)	154	(150)	100	397 (393)	---	(701,810)

GOLD CASH AND CARRY STRADDLE—1978-1980
(continued)

	CONTRACTS—LONG OR (SHORT)						Physical gold	Current balance long (short)	Realized gain (lLoss) per return	Cumulative realized gain (loss) per return
	Mar. 1979	June 1979	Sept. 1979	Dec. 1979	Mar. 1980	June 1980				
18. 1/12/79										
Trade	---	---	---	2	---		---	399 (393)	---	($701,810)
Position	(93)	143	(150)	156	(150)		100			
19. 1/18/79										
Trade	---	---	---	(4)	---		---	395 (393)	$3,480	(698,330)
Position	(93)	143	(150)	152	(150)		100			
20. 1/19/79										
Trade	---	---	---	(2)	---		---	393 (393)	2,970	(695,360)
Position	(93)	143	(150)	150	(150)		100			
21. 1/26/79										
Trade	---	---	---	1	---		---	394 (393)	---	(695,360)
Position	(93)	143	(150)	151	(150)		100			
22. 2/1/79										
Trade	46	---	(46)	---	---		---	394 (393)	(64,900)	(760,260)
Position	(47)	143	(196)	151	(150)		100			
23. 2/5/79										
Trade	30	---	(30)	---	---		---	394 (393)	(52,950)	(813,210)
Position	(17)	143	(226)	151	(150)		100			
24. 2/9/79										
Trade	---	---	---	12	---		---	406 (393)	---	(813,210)
Position	(17)	143	(226)	163	(150)		100			
25. 2/12/79										
Trade	10	---	(10)	---	---		---	406 (393)	(18,890)	(832,100)
Position	(7)	143	(236)	163	(150)		100			
26. 2/15/79										
Trade	7	---	(7)	---	---		---	406 (393)	(14,570)	(846,670)
Position	---	143	(243)	163	(150)		100			

GOLD CASH AND CARRY STRADDLE—1979-1980
(continued)

	CONTRACTS—LONG OR (SHORT)									
	Mar. 1979	June 1979	Sept. 1979	Dec. 1979	Mar. 1980	June 1980	Physical gold	Current balance long (short)	Realized gain (loss) per return	Cumulative realized gain (loss) per return
27. 2/20/79										
Trade	. . .	. . .	. . .	7	. . .		. . .			
Position	. . .	143	(243)	170	(150)		100	413 (393)	. . .	($846,670)
28. 4/24/79										
Trade		. . .	. . .	. . .	(10)		. . .			
Position		143	(243)	170	(160)		100	413 (403)	. . .	(846,670)
29. 5/23/79										
Trade		(143)	143	(150)	150		. . .			
Position		. . .	(100)	20	(10)		100	120 (110)	$431,230	(415,440)
30. 6/26/79										
Trade		. . .	. . .	. . .	(10)		. . .			
Position		. . .	(100)	20	(20)		100	120 (120)	. . .	(415,440)
31. 7/13/79										
Trade		. . .	. . .	(20)	20		. . .			
Position		. . .	(100)	. . .	. . .		100	100 (100)	15,490	(399,950)
32. 7/17/79										
Trade		. . .	100	. . .	(100)		. . .			
Position		. . .	. . .	. . .	(100)		100	100 (100)	(515,240)	(915,190)
33. 8/14/79										
Trade		. . .	. . .	9/(9)	. . .		. . .			
Position		. . .	. . .	. . .	(100)		100	100 (100)	(9,540)	(924,730)
34. 8/30/79										
Trade		. . .	. . .	. . .	(65)		. . .			
Position		. . .	. . .	. . .	(165)					

GOLD CASH AND CARRY STRADDLE—1979-1980
(continued)

	Contracts—long or (short)											
	Dec. 1979	Mar. 1980	May 1980	June 1980	Sept. 1980	Dec. 1980	Mar. 1981	June 1981	Physical gold	Current balance long (short)	Realized gain (loss) per return	Cumulative realized gain (loss) per return
35. 9/4/79												
Trade		65							---	100 (100)	(826,650)	($951,380)
Position		(100)							100			
36. 9/20/79												
Trade	1	---							---	101 (100)	---	(951,380)
Position	1	(100)							100			
37. 9/27/79												
Trade	(1)	---							---	100 (100)	2,120	(949,260)
Position	---	(100)							100			
38. 10/15/79												
Trade	---	(1)							---	100 (101)	---	(494,260)
Position	---	(101)							100			
39/ 10/16/79												
Trade	---	1							---	100 (100)	2,000	(947,260)
Position	---	(100)							100			
40. 10/17/79												
Trade	---	1/(1)							---	100 (100)	900	(946,360)
Position	---	(100)							100			
41. 11/29/79												
Trade	---	100					(100)		---	100 (100)	(1,110,000)	(2,056,360)
Position	---	---					(100)		100			
42. 12/21/79												
Trade	---	---					100	(100)	---	100 (100)	(766,500)	(2,822,860)
Position	---	---					---	(100)	100			
43. 1/17/80												
Trade	---	---			1	(1)	---	---	---	101 (101)	---	(2,822,860)
Position	---	---			1	(1)	---	(100)	100			

GOLD CASH AND CARRY STRADDLE—1979-1980
(continued)

	Contracts—long or (short)												
	Dec. 1979	Mar. 1980	May 1980	June 1980	Sept. 1980	Dec. 1980	Mar. 1981	June 1981	Physical gold	Current balance long	(short)	Realized gain (loss) per return	Cumulative realized gain (loss) per return
44. 3/24/80													
Trade	...	...		(4)	...	...	...	...	...				
Position	...	...		(4)	1	(1)	(100)	100	100	101	(105)	...	($2,822,860)
45. 3/25/80													
Trade	...	...		4	...	...	...	...	...				
Position	...	...		...	1	(1)	...	(100)	100	101	(101)	$3,900	(2,818,960)
46. 4/18/80													
Trade				(1)	...	...	...	...	...				
Position				(1)	1	(1)	...	(100)	100	101	(102)	...	(2,818,960)
47. 4/21/80													
Trade				1	...	...	...	...	...				
Position				...	1	(1)	...	(100)	100	101	(101)	1,850	(2,817,110)
48. 5/1/80													
Trade			(100)	...	...	...	...	...	...				
Position			(100)	...	1	(1)	...	100	100	101	(101)	215,000	(2,602,110)
49. 5/2/80													
Trade			Deliv.	...	...	...	...	...					
Position			...	...	1	(1)	...	...	Deliv.	1	(1)	2,894,712	292,602
50. 5/5/80													
Trade			...	...	(1)	1	...	...					
Position			...	...	...	...	...	...		...	...	900	293,502

TWIN OAKS COMMUNITY, INCORPORATED, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 26160-82. Filed December 3, 1986.

P, a religious or apostolic organization operating as a nonstock corporation under the laws of the Commonwealth of Virginia, conducts various businesses for the common benefit of its members. All the earnings generated by P are deposited in a community treasury maintained by P from which the needs of its members are met. Each year P's members include in their gross income their entire pro rata shares of P's taxable income and properly report it as a dividend received from P. P does not require its members to take a vow of poverty and contribute all of their property, both real and personal, to the community upon becoming members. *Held*, the terms "common treasury" or "community treasury," as used in sec. 501(d), I.R.C. 1954, refer to the communal operation of the religious or apostolic organization itself and do not impose a requirement that all members who join such religious or apostolic organization must take a vow of poverty and irrevocably contribute all of their property to the religious or apostolic organization.

Collins Denny III and *Wallace M. Starke*, for the petitioner.

Scott Anderson, for the respondent.

PARKER, *Judge*: Respondent determined deficiencies in petitioner's Federal income tax as follows:

Year	*Deficiency*
1977	$19,542.74
1978	7,274.55
1979	8,946.01
1980	7,489.00

The issue for decision is whether petitioner, which is otherwise qualified as a tax-exempt organization under section 501(d),[1] satisfies the requirement for a "common treasury" or "community treasury." Resolution of this issue depends on whether the terms "common treasury" or "community treasury," as used in section 501(d), refer only to a religious or apostolic organization that requires its members to take a vow of poverty and totally renounce and completely divest themselves of individual or private ownership of all property, both real and personal, upon becoming members.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in question.

FINDINGS OF FACT

Most of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner Twin Oaks Community, Inc. (sometimes referred to as Twin Oaks), is a religious or apostolic organization. It is a non-stock corporation organized under the laws of the Commonwealth of Virginia.[2] Petitioner's principal office was located in Louisa, Virginia, at the time the petition was filed in this case. Petitioner maintained its books and records and filed its Federal income tax returns using the cash method of accounting and on the calendar year basis. For the taxable years at issue, petitioner filed its Federal tax returns on Forms 1065 (U.S. Partnership Return of Income) with the Internal Revenue Service Center in Memphis, Tennessee.

Twin Oaks is the oldest member of the Federation of Egalitarian Communities (the Federation) and has served as the role model for the creation of many members of the Federation. The original inspiration for the creation of Twin Oaks came from the book entitled "Walden Two," written by the behavioral psychologist, B.F. Skinner. In Walden Two, Skinner describes a utopian community based on reinforcement theories and humanistic approaches to a cooperative lifestyle in which property is held in common and shared and in which the sense of position and wealth is minimized.

In 1967, the organizers of Twin Oaks acquired 123 acres of land along the South Anna River in Louisa County, Virginia, on which a community was established. On February 13, 1973, Twin Oaks was organized as a Virginia non-stock corporation and acquired this property in the same year. At the time of trial, Twin Oaks owned approximately 470 acres of land, of which about 100 acres were farmed.

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[2] See generally Va. Code Ann. secs. 13.1-201 et seq. (Repl. Vol. 1978).

The sole purpose and activity of Twin Oaks has been to organize and operate a religious or apostolic community based on a communal plan in which the members maintain a communal lifestyle following the tenets and teachings of Twin Oaks. The tenets of Twin Oaks are embodied and set forth in Twin Oaks' Statement of Religious Theory and Practice. The tenets and teachings of Twin Oaks involve the promotion of general equality among humanity centering on the basis of spiritual and moral interrelatedness among all people by promoting nonviolence, harmonious cooperation, spiritual awareness, equality, and other similar values through Twin Oaks' physical and social structures and the daily interactions among its members.[3]

Twin Oaks does not sponsor the formal services and liturgies of conventional religions, but rather focuses on creating an environment for the daily practice of its beliefs. Regular meetings are conducted for discussions and lectures on subjects that concern or affect its beliefs. Twin Oaks observes four annual holidays, one on each equinox and one on each solstice, at which times trees are decorated in observance of the change of seasons.

The environment created in the Twin Oaks community in which the members live and work is that of an alternative society, where members may practice their different values and from which the members can carry out and advocate further development of the beliefs and practices of Twin Oaks as a community. The communal living and work structures of Twin Oaks, the egalitarian standard of living practiced by its members, and the regular forums for collective discussion and implementation of the community's beliefs create an effective environment for the realization of Twin Oaks' ideals.

During the taxable years in issue, the membership of Twin Oaks consisted of approximately 65 to 70 adults and as many as 10 children. The members of Twin Oaks are housed on Twin Oaks' property in five large residential buildings and a children's building.

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[3] Petitioner has set out its tenets and beliefs at some length in its requested findings of fact, and respondent has interposed no objection to these requested findings. However, since respondent concedes that petitioner is a religious or apostolic organization, we think it unnecessary to delve any further into the specifics of petitioner's tenets and beliefs.

The members of Twin Oaks engage in farming and gardening, for both commercial purposes and for their own domestic needs. The members also manufacture and sell rope crafts such as hammocks, hammock chairs, and backpacker hammocks. They are also involved in commercial construction contracting, printing, lecturing, and conference leadership.

Each member of Twin Oaks is expected to undertake a fair share of the work of the community, which usually amounts to a minimum of 45 hours per week. Each member's work load is budgeted in a manner similar to a financial budget. Roughly one-third of this work involves income-producing activities, primarily related to the manufacture of rope hammocks and related products. The remainder of each member's work load is devoted to domestic activities, including child care, food production, food preparation, and sewage disposal. Members are also involved in the construction, improvement, maintenance, and repair of Twin Oaks' buildings, machinery, and vehicles used in the conduct of Twin Oaks' activities.

In addition, Twin Oaks provides the services of its members to assist in public social welfare and educational activities, for the benefit of the surrounding communities in Louisa County. Some of these services include assistance in State- and county-supported emergency fuel programs for welfare families and in providing certified teachers to assist in schools attended by children of Twin Oaks' members and nonmembers.

All of the earnings from the various business activities of Twin Oaks are paid into a community treasury maintained by Twin Oaks, from which the needs of the members are met. From this community treasury, Twin Oaks provides for its members all food, clothing, housing, medical, and other personal needs appropriate to the philosophy of the community. Direct medical benefits are limited to preventative and emergency care, with benefits for pregnancy, parturition, and other treatment being discretionary. In addition, Twin Oaks entered into a medical insurance policy for the benefit of its members. Any additional medical expenses of members are covered by advances to the members from the community treasury. Repayment of these advances is not required if the individual continues as a member for a certain period of time after the advance has been made.

In addition to community needs provided to its members directly from the Twin Oaks' community treasury, certain other financial allowances are permitted. Each member of Twin Oaks is allotted between $7 and $10 per month for personal spending money. Each member can earn $1 per hour for community income-producing work in excess of his budgeted weekly work requirement. Moreover, a member who terminates membership in Twin Oaks and leaves the community is paid a "leaving fund" of $50 from the community treasury to assist in transportation costs. Upon termination, a member is also entitled to begin receiving repayment of any loans previously made to Twin Oaks, but is not entitled to any other portion of the Twin Oaks' community treasury. However, in the event of the dissolution of Twin Oaks, each member at the time of dissolution will be granted a "leaving fund" of $1,000.

Twin Oaks also allows its members to take vacations outside the County of Louisa, Virginia. Members are permitted to earn small amounts of money to spend on these vacations, but no amount can be spent in the County of Louisa.

One aspect of Twin Oaks' philosophical practices is to eliminate the effects of major material values and trappings from the life of its members within the Twin Oaks community. Twin Oaks is designed to create an atmosphere in which there is complete equality among its members within a community that shares in a modest material existence.

In furtherance of these beliefs and practices, Twin Oaks requires its members to insulate themselves from all private possession of property. However, members are allowed to receive gifts of cash and other items valued at no more than $35 per year. In addition, members are allowed to retain certain "permitted personal effects," which may be kept in the member's designated private living space, provided that such items are not deemed by Twin Oaks to be unsuitable in its environment or damaging to its philosophy of equality.

All larger personal, tangible assets that are brought
members to the Twin Oaks community must be ei
loaned or donated to Twin Oaks. For instance, licen
motor vehicles brought to the community must be re
tered in Twin Oaks' name. Twin Oaks is entitled to mak
decisions regarding insurance and maintenance of the v
cle on the basis of its usefulness to the commun
However, if an individual's membership in Twin Oaks
terminated, any vehicle loaned by him to Twin Oaks
returned and reregistered in his name. Vehicles donated
Twin Oaks remain the property of Twin Oaks following
termination of the donor's membership.

To the extent that a member may own assets other th
such "permitted personal effects," either (a) such ass
must be placed in a non-income-producing status, (b) inco
earned on such assets (including dividends, interest, a
realized capital gains on securities) must be paid over to t
community treasury of Twin Oaks, or (c) such assets mu
be lent to Twin Oaks for its use without interest or oth
charges in respect thereto. In addition, members must agr
that Twin Oaks shall become entitled to all appreciation
the value of any assets of the member sold during t
period of his membership.

During the taxable years in issue, Twin Oaks operat
under two sets of operational documents. Twin Oa
operated under one set of operational documents unt
October 19, 1979, and under another set thereafter. Th
operational documents included bylaws, community prop
erty code, working government description, and forms fo
membership agreements.

Both the original and revised operational document
provided for two classes of membership in Twin Oak
provisional members and full members. Twin Oaks generall
required a 6-month provisional membership period. Wit
respect to private ownership of property, neither set of th
Twin Oaks bylaws required its members to take a vow o
poverty and to completely divest themselves of all individ
ual property ownership upon becoming members. Members
could retain title to real, personal, or intangible assets
located outside the community. However, members were
required to donate to the community all the income, if any,

generated from these assets. In addition, except for permitted personal effects, all property brought to the community was either donated or loaned to Twin Oaks for the benefit of the community. Any money or property loaned to Twin Oaks was required to be returned or repaid upon a member's termination.

Until the revision in October of 1979, the Twin Oaks bylaws contained a provision that provided that each member shall, as part of his membership agreement, establish a schedule for the eventual donation to the organization of all his property, except petty property. The schedule had to conform to the explicit community policy as of the time of joining. The membership agreements, in effect until October 19, 1979, essentially provided two different schedules that members could follow. Schedule A provides in pertinent part that the member will donate all property (except petty property) in various installments within 7 years, and Schedule B is identical in all material respects but provides a 12-year timetable. After October 19, 1979, and through December 31, 1980, Twin Oaks' bylaws eliminated any requirement that its full members donate all of their property.[4]

At no time during the years at issue did any member of Twin Oaks have any rights to property owned by Twin Oaks or to income (whether earned or contributed) of Twin Oaks, other than the rights to support and maintenance by Twin Oaks as described above.

Petitioner presented testimony by an expert on utopian and religious communities, who contrasted the Benedictine Monks who require an absolute vow of poverty as part of their religious way of life and the Shakers who have a less restrictive property code. Before their recent decline, the Shakers were a religious, communal organization with three classes of member: novitiate, a middle level, and full members. At the novitiate level, members were allowed to retain possession of their property. At the middle level, a member's property ownership and control was minimized, but he was only required to place it with the Shaker organization, and he could reclaim it upon terminating membership. Upon achieving full membership, a membe was required to give all his property to the Shake organization. The Shaker constitution provided that if a full member left the organization he could reclaim some of the property he donated, and the practice was for the Shake organization to turn over to the departing full membe enough assets to allow him return to more conventional society in substantially the same position as he had left it The Shakers' system of property regulation was derived from their religious belief in trying to follow a system of life dictated by scriptural passages.

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[4] Twin Oaks' bylaws were again changed effective Jan. 1, 1981, and respondent has recognized Twin Oaks' exemption under sec. 501(d) effective Jan. 1, 1981.

The regulation of private ownership of property is common in communal organizations and is essential to setting the standard by which the lives of members within the organization are organized. The degree to which a communal organization regulates property ownership by its members depends upon the objectives which the organizatio seeks to achieve. The religious objective of Twin Oaks is to create a community based upon the philosophy of human ism in which people help one another, share the product o their efforts, and minimize all sense of position and wealth Twin Oaks' system of property regulation, as contained in its bylaws which were in effect from October 19, 1979 through December 31, 1980, had the effect of only requiring its members to insulate themselves from the economic effects of private property ownership without requiring an absolute vow of poverty under which all private ownership of property is renounced. Such a system of property regulation is sufficient to achieve the religious objectives o Twin Oaks.

During the taxable years in issue, petitioner considered itself taxexempt pursuant to section 501(d), and accordingly filed its Federal income tax returns for each of these years on Form 1065 (U.S. Partnership Return of Income). Each such return included a Schedule K-1 (or a substitute therefor in 1980) for each member of Twin Oaks. Al Schedules K-1, or substitutes therefor, for each respective year in issue were identical, with the exception that each Schedule K-1, or substitute, for a particular year had different "partner's identifying number" and partner's name, address, and Zip Code. In addition, the Schedules

K-1, or substitutes, for a member who joined or left during a year in issue reflected only income, credits, and deductions attributable to the member's period of membership in Twin Oaks. Each member of Twin Oaks, during the years in issue, included in his or her gross income his or her entire pro rata share of Twin Oaks' taxable income for that year in accordance with the Schedules K-1, or substitutes therefor, attached to petitioner's Form 1065 for such year.

By statutory notice of deficiency dated August 13, 1982, respondent determined that Twin Oaks was not an organization described in section 501(d) during the taxable years 1977 through 1980, and that its income for those years was not properly reported on Form 1065 (U.S. Partnership Return of Income). Accordingly, respondent recomputed petitioner's Federal income tax liability on Form 1120 (corporate return) for each year in issue based on the information contained in Twin Oaks' Forms 1065.[5]

OPINION

Section 501(a) exempts from taxation an organization described in section 501(d).[6] Section 501(d) describes such an organization as follows:

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[5] The parties have now stipulated that if Twin Oaks is not exempt from tax under sec. 501(d) for the years in issue, then Twin Oaks' Federal income tax liability for the years in issue is as follows:

Year	*Tax liability*
1977	$9,971.68
1978	4,850.58
1979	7,225.57
1980	7,535.01

The parties further stipulated that if Twin Oaks is exempt from tax under sec. 501(d) for the 1977 and 1978 taxable years and for the portion of the 1979 taxable year until Oct. 19, 1979, but is not so exempt for the balance of the 1979 taxable year or for the 1980 taxable year, then Twin Oaks' income tax liability is as follows:

Year	*Tax liability*
Short period	
Oct. 19, 1979-Dec. 31, 1979	0
1980	$2,958.57

The record does not explain why the tax liability for 1980 differs in the two situations of nonexemption.

[6] Sec. 501(a) provides as follows:

(a) EXEMPTION FROM TAXATION.—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

> SEC. 501(d). RELIGIOUS AND APOSTOLIC ORGANIZATIONS.—The following organizations are referred to in subsection (a): Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

There is no dispute that petitioner meets three of the four requirements for exemption under section 501(d). Petitioner is a religious or apostolic corporation. Petitioner engages in a manufacturing and sales business for the common benefit of its members. Petitioner's members include in their gross income as dividends received their entire pro rata share of petitioner's taxable income, whether or not such income is actually distributed to them. The only issue in this case is whether petitioner maintains a common treasury or community treasury.

Respondent contends that the terms "common treasury" or "community treasury," as used in section 501(d), impose a requirement that members of such a religious or apostolic organization must take a vow of poverty and irrevocably contribute all of their property, both personal and real, to the organization upon becoming members and not be entitled to any part of that property upon leaving the organization. Respondent argues that the property codes in effect for Twin Oaks during the years in issue do not require its members to donate their property to the organization, and, therefore, Twin Oaks was not an organization described in section 501(d) during these years. Petitioner contends that property that members may or may not own outside of the religious or apostolic organization is irrelevant to the determination whether the organization is described in section 501(d). Petitioner argues that the terms "common treasury" or "community treasury," as used in section 501(d), describe an arrangement where all profits generated by the community business are placed into a community treasury and no member has any right to receive or enjoy any of the assets in the community treasury, except for support and maintenance. We must decide, as an issue of first impression, the meaning of the terms "common treasury" and "community treasury" as used in section 501(d).

Unfortunately, these terms are not defined in the Code or in the regulations. The regulations simply track the language of the statute and provide little assistance.[7] Moreover, the parties have not cited, and we have not found, any case construing the meaning of "common treasury" or "community treasury," as used in section 501(d). Consequently, we must look to the language of the statute and its legislative history in construing these terms so as to give effect to the intent of Congress. *United States v. American Trucking Associations*, 310 U.S. 534, 542-545, rehearing denied 311 U.S. 724 (1940).

Section 501(d) was originally enacted into law as section 101(18) as part of the Revenue Act of 1936. Section 101(18) has effectively survived subsequent legislation and essentially was reenacted verbatim in the 1939 Code and as section 501(d) of the 1954 Code.[8] The legislative history accompanying the original enactment of this provision is rather scanty and the congressional intent somewhat obscure. The legislative history consists primarily of comments made by Senator Couzens during a hearing before the Senate Finance Committee on the Revenue Act of 1936 where he expressed a need for a specific provision to change the then existing method of taxing certain religious and apostolic organizations, and remarks made by Senator Walsh on the floor of the Senate at the time he introduced the amendment that was eventually adopted as section 101(18) of the Revenue Act of 1936. Respondent argues that the remarks of Senator Couzens to the Senate Finance

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[7] Sec. 1.501(d)-1(a), Income Tax Regs., provides as follows:

> Religious or apostolic associations or corporations are described in section 501(d) and are exempt from taxation under section 501(a) if they have a common treasury or community treasury, even though they engage in business for the common benefit of the members, provided each of the members includes (at the time of filing of his return) in his gross income his entire pro rata share, whether distributed or not, of the net income of the association or corporation for the taxable year of the association or corporation ending with or during his taxable year. Any amount so included in the gross income of a member shall be treated as a dividend received.

[8] Sec. 101(18) of the Revenue Act of 1936 was reenacted verbatim in the 1939 Code, sec. 101(18), 53 Stat. 35, 76th Cong., 1st Sess. (1939), and was reenacted as sec. 501(d) in the 1954 Code. Sec. 501(d), 68A Stat. 165, 83d Cong., 2d Sess. (1954). Except for using the term "taxable income" rather than "net income," sec. 501(d) is essentially identical to sec. 101(18) as originally enacted in the Revenue Act of 1936.

Committee and Senator Walsh's statement on the Senate floor suggest that section 101(18), now section 501(d), was intended only for those religious or apostolic organizations that require their members to take vows of poverty and divest themselves of all property upon joining the organization. Comments by individual members provide an uncertain guide as to the intent of the legislative body.[9] More importantly, these comments were general descriptions of some types of religious or apostolic organizations, not definitions of the terms "common treasury" or "community treasury." Respondent tries to use these general descriptions of certain types of religious or apostolic organizations to circumscribe the meaning of common treasury or community treasury. However, we note that the term "religious or apostolic associations or corporations" is itself not defined in the statute, although Senator La Follette pointed out to Senator Couzens the inherent definitional problems.

The need for a provision, changing the then-existing law of taxing certain religious and apostolic organizations as corporations, was originally brought to the attention of the Committee on Finance by Senator Couzens during a hearing on the Revenue Act of 1936. In that hearing, the following exchange occurred:

> SENATOR COUZENS. I hesitate to do this, but there has been a long controversy about taxing these apostolic organizations who have a community interest, such as the House of David, the Shakers, and so on, the Holy Rollers, and all of those. They are not permitted to deduct the married man's or single man's allowance, and they are taxed as a corporation. *When they enter these organizations, they put in all of their property, I understand, and do a community business*, run community

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[9] In *Duplex Printing Press Co. v. Deering*, 254 U.S. 443, 474-475 (1921), the Supreme Court stated:

"By repeated decisions by this court it has come to be well established that the debates in Congress expressive of the views and motives of individual members are not a safe guide, and hence may not be resorted to, in ascertaining the meaning and purpose of the law-making body. *Aldridge v. Williams*, 3 How. 9, 24; *United States v. Union Pacific R. R. Co.*, 91 U. S. 72, 79; *United States v. Trans-Missouri Freight Association*, 166 U. S. 290, 318. But reports of committees of House or Senate stand upon a more solid footing, and may be regarded as an exposition of the legislative intent in a case where otherwise the meaning of a statute is obscure. *Binns v. United States*, 194 U. S. 486, 495. And this has been extended to include explanatory statements in the nature of a supplemental report made by the committee members in charge of a bill in course of passage. *Binns v. United States, supra*; *Pennsylvania R. R. Co. v. International Coal Co.*, 230 U. S. 184, 198-199; *United States v. Coca Cola Co.*, 241 U. S. 265, 281; *United States v. St. Paul Minneapolis & Manitoba Ry. Co.*, 247 U. S. 310, 318."

farms, and all of the revenue is put in one pot and they are taxed as a corporation, and the married people in these organizations are not permitted to deduct anything for being married, or the single men for being single. So they have been imposed on for a number of years by that application of the law to them.

I would like, if there is not too much objection, to have an amendment drawn and later submitted to the committee covering that question. There are a number of organizations throughout the Nation who are very adversely affected, and it does seem to me an antireligious procedure to follow in the tax law.

SENATOR WALSH. Of course, there is no objection.

SENATOR KING. Mr. Beaman, I talked this over with you and some of the other experts the other evening down in your rendezvous. Did you prepare something?

MR. PARKER. This is a rather difficult proposition.

SENATOR LA FOLLETTE. It seems to me this is something that could be handled by the Bureau.

SENATOR COUZENS. I do not want to take up the committee's time, but I have here a memorandum of a memorandum of law, opinion 550, which was issued in 1916, and a memorandum signed by Mr. Ballantine, June 1918, in which they took no cognizance of it.

SENATOR LA FOLLETTE. The trouble is they held that these people are not religious organizations because they do not belong to an accepted religion, but to them it is just as much a religion as any other kind of a religion.

SENATOR COUZENS. It does not seem to me that there is any justification for it at all.

SENATOR LA FOLLETTE. If you would hold that they are a religion, they would get out under section 101.

MR. KENT. I do not think so—

SENATOR WALSH (interposing). Can we agree that the amendment can be ordered and submitted to the committee later?

MR. KENT. I do not believe that section 101 is broad enough to cover them, because that provides that no part of the earnings shall inure to any individuals. These people are getting individually the benefits of community earnings even though the funds as such are not divided between them.

SENATOR COUZENS. Yes; but they are not getting the benefit of the earnings to the extent that the married man gets an exemption of $2,500. They probably make $500 or $600, and an ordinary person would be exempt and they are not exempt.

SENATOR LA FOLLETTE. If you just decide they were a religious organization, then you would be confronted with the decision on section 101, and you could have taken care of it that way, and it is a lot easier than trying to put something in the law, because it is going to look very funny when you get through with it, I do not care how long you and Mr. Beaman and Mr. O'Brien work on it.

SENATOR KING. Prepare an amendment covering that.

SENATOR COUZENS. And you can submit it to me.

[Hearings on H.R. 12395 Before the Senate Comm. on Finance, 74th Cong., 2d Sess., Part 11, at 46 (1936). Emphasis added.]

We have no further information or background about the drafting of the actual language. Respondent contends that Senator Couzens' remarks to the Committee on Finance show that the type of organization he contemplated section 101(18), now section 501(d), to exempt was one that required its members to "put in all of their property" when they entered the community. However, the statute contains no definition of the type of religious or apostolic organization to be benefited, and requirements such as a vow of poverty or irrevocable contribution of all property, if intended, could have been easily spelled out.

When proposing the amendment that was finally adopted by the Revenue Act of 1936 as section 101(18), Senator Walsh made the following statement:

> MR. WALSH. Mr. President, under existing law religious, educational, and charitable corporations are exempt from taxation under the income tax title.
>
> This amendment adds a new paragraph to section 101 of the revenue act, which exempts certain corporations from taxation under the income tax title.
>
> It has been brought to the attention of the committee that certain religious and apostolic associations and corporations, such as the House of David and the Shakers, have been taxed as corporations, and that *since their rules prevent their members from being holders of property in an individual capacity* the corporations would be subject to the undistributed-profits tax. These organizations have a small agricultural or other business. The effect of the proposed amendment is to exempt these corporations from the normal corporation tax and the undistributed-profits tax, if their members take up their shares of the corporations' income on their own individual returns. It is believed that this provision will give them relief, and their members will be subject to a fair tax.
>
> [80 Cong. Rec. 9074 (June 5, 1936). Emphasis added.]

Respondent further argues that Senator Walsh, in explaining the purpose of section 101(18), the predecessor of section 501(d), indicated that an organization exempt from taxation under this section would have rules to "prevent their members from being holders of property in an individual capacity." However, we think that respondent has taken these comments out of context and has overemphasized the significance of these remarks. The proper context seems to be the matter of the undistributed profits tax, which the amendment solved by making all net income taxable to the members, whether or not distributed. When read in proper context, we find it difficult to view Senator Walsh's comment as defining a religious or apostolic association or corporation, let alone as defining the terms "common treasury" or "community treasury."

From our reading of the meager legislative history, we find little support for respondent's argument. The interpretation of the terms "common treasury" and "community treasury," as suggested by respondent, furthers neither the purpose nor the effect of the statute. The purpose of section 101(18), now section 501(d), was to correct the inequity of taxing certain religious and apostolic organizations as corporations without their members having the benefit of deducting the married man's or single man's allowance. Hearings on H.R. 12395 Before the Senate Comm. on Finance, 74th Cong., 2d Sess., part 11, at 46 (1936). The effect of section 101(18), now section 501(d), eliminates the normal corporate tax and the potential undistributed profits tax on certain religious and apostolic organizations that are attributable to the income generated by these organizations, provided, however, the members of such organizations include in their gross income their entire pro rata shares of the organization's income, whether distributed or not. 80 Cong. Rec. 9074 (June 5, 1936).

Both the purpose and effect of section 101(18), now section 501(d), focus on the income generated by these religious or apostolic organizations that maintain a common or community treasury. Respondent has not presented and we have not found any connection between the purpose and effect of the statute and respondent's attempt to restrict its applicability to only those religious or apostolic organizations that require their members to take vows of poverty and divest themselves of all property ownership.

If anything, the comments made by Senator Couzens and Senator Walsh weaken rather than support respondent's position. We find it significant that both Senator Couzens and Senator Walsh specifically named the *Shakers* as one of the organizations for which section 101(18) was intended to apply. Respondent concedes on brief and the record establishes that the Shaker community did not require all of its members to take vows of poverty and completely divest themselves of all individual property ownership outside of the organization.[10] However, respondent speculates that Senator Couzens and Senator Walsh believed that Shaker communities had rules prohibiting the ownership of private property, and, therefore, whether or not these rules actually existed is irrelevant. We reject such speculation. In the absence of anything to the contrary, we must assume that Congress was cognizant of all the relevant facts surrounding the enactment of this Code section.

In any event, we think the statements in the scanty legislative history referring to property ownership in connection with certain religious and apostolic organizations are merely illustrative rather than definitive. These statements that respondent places so much emphasis upon are at best brief descriptions of the internal rules of certain religious or apostolic organizations and do not amount to a legislative requirement that members of such organizations must take vows of poverty in order for the organization to obtain the benefits of what is now section 501(d). We agree that the concept of a common or community treasury maintained by the organization for the maintenance and support of its members connotes that the property of such organizations not be held by members individually but rather held in a "community capacity" with all members having equal interests in the community property. We think that on the facts of this case, Twin Oaks maintains and operates such a common or community treasury as to the organization's communal property and communal income. However, we think the requirement for a common or community treasury does not mean that members are necessarily prohibited from owning property outside and apart from the organization. We simply do not read the terms "common treasury" and "community treasury" as requiring members of section 501(d) organizations to take vows of poverty and as prohibiting them from owning property individually outside and apart from such organizations.

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[10] The Shaker community provided three levels of membership. The first order, called the novitiate class, consisted of members who had received the gift of faith but had chosen to live with their natural families and direct their own temporal affairs. Members of the second class still owned property but ceased using all or part of it in order to join the production-consumption cooperative that constituted the economic infrastructure of the community. Members of the the third class categorically renounced all of their property, which became a part of the common, jointly held, inalienable property of the society. However, if full members left the Shaker community, they were given property to help them return to the outside world.

In addition, we think that the limited tax relief afforded by section 501(d) does not mandate the imposition of such restrictive requirements on these organizations. Unlike section 501(c)[11] that essentially provides a total tax exemption to organizations described therein, section 501(d) exempts the organization from tax but shifts the liability for such taxes to its members, who must report their pro rata shares of the organization's income. Section 501(d) simply prevents the potential double tier of taxation by eliminating the corporate tier of tax on the organization and allowing a single level of tax to be imposed on the individual members. This exemption, however, is contingent on the members reporting their pro rata shares of the organization's income. As described in *Kleinsasser v. United States*, 707 F.2d 1024, 1025-1026 (9th Cir. 1983):

> Section 501(d) was intended to provide tax relief for religious organizations that have a common or communal treasury. Without § 501(d), the income of a religious corporation * * * would be subject to the regular corporate income tax at the corporate level, and, if distributed to organization members, the individual income tax at the shareholder level. If the corporate income were not distributed, the corporation would pay both the corporate income tax and the accumulated earnings tax. Section 501(d) eliminates the corporate level of taxation and leaves a single tier of individual income taxation. The scanty legislative history suggests that this single tier of taxation was believed to be the fair way to tax members of § 501(d) organizations.

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[11] Organizations listed under sec. 501(c) are subject to tax imposed by sec. 511 on any unrelated business taxable income as defined in sec. 512. Since a sec. 501(d) organization, by definition, engages in business for the benefit of its members, there can be no unrelated trade or business, no unrelated business taxable income, and no investment tax credit in connection with unrelated business taxable income for sec. 501(d) organizations. See *Kleinsasser v. United States*, 707 F.2d 1024 (9th Cir. 1983). We note that sec. 1879(j)(1) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2908 changed the result in that case by providing that solely for purposes of the investment tax credit, the sec. 501(d) organization is to be treated as an unrelated trade or business and that the investment credit is to be passed through pro rata to the members. However, if a member is otherwise entitled to an investment credit, he would lose the benefit of his pro rata share of the investment credit, and no other person could receive the benefit of his pro rata share. This change in the law was made retroactive to periods after Dec. 31, 1978, and sec. 501(d) organizations have a year within which to file refund claims in regard to these investment tax credits.

In addition, in setting forth the requirements for exempt under section 501(d), the Ninth Circuit stated:

> The only requirements for the exemption are that there be a com treasury, that the members of the organization include pro rata share organization income when reporting taxable income and, implicitly, the organization have a religious or apostolic character. Once requirement of form is fulfilled, the exempt organization is unlimite to function. * * * If the organization had income that it failed to allo to its members, it would simply lose its exemption altogether. [*Klein ser v. United States*, *supra*, 707 F.2d at 1029.]

Furthermore, the Ninth Circuit indicated that the exer tion under section 501(d) was not limited to nonmateriali sects.[12] The court stated that "The members of a sect 501(d) organization could live in luxury as long as income is allocated pro rata and reported on the memb individual tax returns." *Kleinsasser v. United States*, F.2d at 1029 n. 3.

Thus in view of the limited tax relief afforded by sect 501(d), we find no reason for distinguishing between r gious or apostolic organizations that require their memb to divest themselves of all property ownership and th that do not. Indeed, this limited tax relief provides lit room for potential abuse of section 501(d). If a sect 501(d) organization permits its members to own prope outside and apart from the organization, any income gen ated by such property is simply reported on the membe individual income tax return, in addition to his Sched

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[12] In an earlier and the first reported case where any court had generally construed application of section 101(18), the predecessor of sec. 501(d), the Ninth Circuit stated:

"One might assume, then, that Congress intended an association somewhat akin to ordinary association or partnership in which each member has a definite, though undivi interest in the business conducted for the common benefit of the members, as well common interest in the community treasury and property. The business and benefit menti appears to be something more tangible and worldly than spiritual comfort though the com community enterprise is to be related to or associated with a religious group and doctrine, being under the aegis of that group. The Church with which we are here concerned would fall within the exemptive provisions of Section 101(18). [*Riker v. Commissioner*, 244 F.2d 230 (9th Cir. 1957), affg. a Memorandum Opinion of this Court, cert. denied 355 U.S. (1957).]"

Although the Ninth Circuit noted in *Riker* that its comments concerning sec. 101(18) simply gratuitous, the court's emphasis was on the member's relationship with respect to organization's business ventures and the community treasury rather than on the religious spiritual aspects of the member's relationship with the organization. Here we need not con ourselves with such emphasis since respondent concedes that petitioner is a religious apostolic corporation.

K-1 pro rata share of the organization's taxable income. Moreover, the member includes this other income regardless of whether or not he is required to contribute, donate, or loan such income to the organization. Also, if the member must contribute such income to the organization, as Twin Oaks' members were required to do, such contributions to section 501(d) organizations are not deductible by the member. Since these organizations operate on a communal basis with a common treasury that is used for the support and maintenance of its members, the organization's income clearly inures to the benefit of the members, and thus is not a qualified donee organization under section 170. See *Riker v. Commissioner*, 244 F.2d 220 (9th Cir. 1957), cert. denied 355 U.S. 839 (1957). The Commissioner has taken the same position that contributions to section 501(d) organizations are not deductible, and petitioner does not suggest otherwise. Rev. Rul. 57-574, 1957-2 C.B. 161.

Also pursuant to section 501(d), members must include their pro rata shares of the organization's income and report such income as a dividend or, in effect, as ordinary income. In addition, the standard dividend exclusion provided by section 116(a) does not apply to dividends received from section 501(d) organizations. Sec. 116(b).[13] Consequently, regardless of the character of income generated by section 501(d) organizations, all such income is reported by the members as ordinary income. Moreover, the pro rata shares of the organization's taxable income that members report as dividends received do not constitute earnings from self employment (*Blume v. Gardner*, 262 F. Supp. 405 (W.D. Mich. 1966)), and the support and maintenance furnished by 501(d) organizations to their members do not constitute wages for Federal employment tax purposes. *Israelite House of David v. United States*, 58 F. Supp. 862 (W.D. Mich. 1945). In summary, we see numerous limitations and restrictions on the benefits conferred by section 501(d) and little potential for abuse. In the absence of some indication in the language of the statute itself or some stronger indication in its sparse legislative history, we see no reason to graft on additional requirements to section 501(d), as respondent asks us to do.

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[13] We note that sec. 116 relating to partial exclusion of dividends received by individuals has been repealed effective for taxable years beginning after Dec. 31, 1986. Sec. 612(a), Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2250.

Thus, the interpretation of the terms "common treasury" and "community treasury" as urged by respondent necessitates imposing a requirement on section 501(d) organizations that is neither contained in the Code nor the regulations thereunder. Respondent urges us to impose this additional requirement based entirely on the remarks of Senator Walsh and Senator Couzens contained in the scanty legislative history. However, absent a clearer statement of legislative intent that we should interpret the terms "common treasury" and "community treasury" as respondent suggests, we find it difficult to do so. Furthermore, "it is not the function of a Court to rewrite or amend a statute in the guise of construing it." *David Metzger Trust v. Commissioner*, 76 T.C. 42, 59-60 (1981), affd. 693 F.2d 459 (5th Cir. 1982), cert. denied 463 U.S. 1207 (1983).

Respondent nevertheless contends that he has consistently interpreted the terms "common treasury" and "community treasury" as used in section 501(d) to mean that an organization otherwise described under that section must require its members to contribute all of their property to a common treasury upon joining the organization. Respondent cites three revenue rulings to support this contention.[14] We note, of course, that revenue rulings merely represent the position of one of the litigants in this case. *Reinhardt v. Commissioner*, 85 T.C. 511, 520 (1985); *Crow v. Commissioner*, 85 T.C. 376, 389 (1985). As such, revenue rulings are not binding on the courts. *Stubbs, Overbeck & Associates v. United States*, 445 F.2d 1142, 1146-1147 (5th Cir. 1971). However, revenue rulings may be helpful in interpreting a statute and may be considered on their own intrinsic merit and persuasiveness or lack thereof. In any event, the revenue rulings cited by respondent are neither contemporaneous interpretations of the statutory language nor directly on point. These revenue rulings do not address the issue presented herein, and we find them unpersuasive as to our issue.

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[14] Rev. Rul. 78-100, 1978-1 C.B. 162; Rev. Rul. 58-328, 1958-1 C.B. 327; Rev. Rul. 57-574, 1957-2 C.B. 161.

In Rev. Rul. 78-100, 1978-1 C.B. 162, respondent determined that organizations supported by members' outside wages earned independently from the organization do not qualify for exemption under section 501(d). Organizations contemplated by section 501(d) are those that are supported by internally operated businesses in which all the members have an individual interest. In Rev. Rul. 58-328, 1958-1 C.B. 327, respondent determined that no part of a member's pro rata share of the taxable income of a section 501(d) organization (whether distributed or not) is includable in the computation of his net earnings from self-employment for purposes of the Self-Employment Contributions Act of 1954. In Rev. Rul. 57-574, 1957-2 C.B. 161, respondent determined that contributions to a section 501(d) organization which, in addition to the conduct of its religious and communal activities, is engaged in the operation of a commercial enterprise the proceeds of which inure to the common benefit of its members, are not deductible under section 170 and amounts paid or permanently set aside by a trust or estate for such an organization are not allowable as a deduction under section 642(c). In addition, bequests, legacies, devises, or transfers, or gifts of property to such organizations are not deductible for estate or gift tax purposes under section 2055 or section 2522.

These rulings simply are not dispositive of the issue before this Court and deal with the present issue only in an indirect, oblique manner. The only reference in these rulings to the property rights of the individual members is merely recited in the factual statement upon which two of those rulings are premised. In Rev. Rul. 78-100, *supra*, members of the organization described therein take vows of poverty and contribute all of their property to a common treasury. In Rev. Rul. 57-574, *supra*, each member, upon joining the organization described therein, completely surrenders to the organization all property of which he is possessed. Rev. Rul. 58-328, *supra*, contains nothing to indicate that members of section 501(d) organizations described therein take vows of poverty and contribute all of their property to the organization. In fact, Rev. Rul. 58-328, *supra*, appears to indicate to the contrary. This ruling indicates that section 501(d) organizations are permitted to distribute their profits to the members, which seems to be inconsistent if members o such organizations are required to take vows of poverty. I any event, these rulings are factually distinguishable, d not address our issue, and are unpersuasive in that regard While we have no argument with the holdings of any o these revenue rulings, they cannot be read as a consisten interpretation, or indeed, as any interpretation at all, of th terms "common treasury" or "community treasury."

Subchapter F contains various provisions where Congres has afforded certain organizations tax-exempt status. Som of the provisions provide greater or lesser tax relief tha others. However, we are not aware of any tax-exemp provision contained in the Code where Congress has imposed on any organization the requirements that responden urges us to impose on section 501(d) organizations. Moreover, respondent has not articulated, and we have not found, any reason why Congress would restrict sectio 501(d) to only those organizations otherwise described unde such section that require members to take vows of poverty and renounce ownership of private property. In the absenc of statutory language or some clear legislative history to that effect, we cannot read the bare terms "commo treasury" or "community treasury" as imposing such requirements.

The focus of section 501(d) is on the income generated by certain religious or apostolic organizations. In the absenc of anything to the contrary, we conclude that an organization has a "common treasury" or "community treasury," as used in section 501(d), when all of the income generated internally by community-operated businesses and any income generated from property owned by the organization is placed into a common fund that is maintained by such organization and is used for the maintenance and support of its members, with all members having equal, undivided interests in this common fund, but no right to claim title to any part thereof. Twin Oaks satisfies those requirements. Whether or not Twin Oaks as a religious or apostolic organization requires its members to take vows of poverty and dispose of all their property holdings outside of the organization is irrelevant to the meaning of the terms "common treasury" or "community treasury" as used in section 501(d). Accordingly, since we find that Twin Oaks had a common or community treasury and since the parties have stipulated that petitioner otherwise satisfies the requirements of section 501(d) for the years in issue, we hold for petitioner.[15]

Decision will be entered for the petitioner.

LOUIS E. ROSZKOS AND VIVIAN L. ROSZKOS, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 45403-85. Filed December 4, 1986.

P and R executed an open-ended consent (Form 872-A) to extend the period for assessment. R sent two notices of deficiency to addresses which were not P's "last known address." P did not receive the notices and R assessed and collected the tax from P. The terms of the consent provided for termination if R mailed a notice of deficiency or assessed the tax. More than 90 days after the mailing of the two notices, P petitioned this Court and then moved for dismissal on grounds that the notices were not sent to P's "last known address" and R posed no objection. We dismissed. R mailed a new notice of deficiency to P which would be timely mailed if the open-ended consent has not been terminated by the prior two notices and assessment. P contends the statute has expired and respondent contends that the earlier two notices and assessment were a "nullity" and had no effect upon the consent. R contends, in the alternative, that he can invoke jurisdiction of this Court under the holding in *Wallin v. Commissioner*, 744 F.2d 674 (9th Cir. 1984). *Held*, the consent was terminated when P subsequently became aware of the notices during the collection process. *Held, further*, the holding in *Wallin v. Commissioner, supra*, is not available to R to force P into court on the merits where R's lack of diligence is the foundation for such equitable relief.

Woodford G. Rowland, for the petitioners.
Thomas M. Rohall, for the respondent.

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[15] Petitioner argues that an interpretation of section 501(d) as suggested by respondent would interfere with Twin Oaks' ability to carry out its religious beliefs, which would raise serious First Amendment issues. However, because of our disposition of the issue in this case, we find it unnecessary to address these constitutional issues.

GERBER, *Judge*: Respondent, in a notice of deficiency dated October 28, 1985, determined deficiencies in petitioners' 1973 and 1974 Federal income taxes in the amounts of $33,178 and $36,136, respectively. Petitioners filed a timely petition reflecting a legal residence of Alamo, Califor Petitioners, on January 21, 1986, moved to dismiss for lack of jurisdiction on the ground that respondent's October 28, 1985, notice was mailed beyond the 3-year statutory period within which to assess tax. The circumstances preceding the issuance of the notice are unique and give rise to the following novel issues: (1) Whether a notice of deficiency which is not mailed to the last known address is sufficient to terminate an open-ended consent (Form 872-A) to extend the assessment period; and (2) where respondent has not exercised reasonable diligence in determining a taxpayer's last known address, may respondent invoke the jurisdiction of this Court under the holding in *Wallin v. Commissioner*, 744 F.2d 674 (9th Cir. 1984), revg. a Memorandum Opinion of this Court.

FINDINGS OF FACT

Petitioners' 1973 and 1974 taxable years were under consideration by respondent. Several consents to extend the statute of limitation on assessment were executed periodically by the parties. Eventually, the parties executed a Special Consent to Extend the Time to Assess Tax, Form 872-A (rev. July 1979). Form 872-A is essentially an open-ended consent, the pertinent terms of which are as follows:

> taxpayer(s) * * * and [respondent] consent and agree as follows: (1) The amount(s) of any Federal ______ tax due on any return(s) made by or for the above taxpayer(s) for the period(s) ended ______, may be assessed on or before the 90th (ninetieth) day after: (a) the Internal Revenue Service office considering the case receives Form 872-T, Notice of Termination of Special Consent to Extend the Time to Assess Tax, from the taxpayer(s); or (b) the Internal Revenue Service mails Form 872-T to the taxpayer(s); or (c) the Internal Revenue Service mails a notice of deficiency for such period(s). However, if a notice of deficiency is sent to the taxpayer(s), the time for assessing the tax for the period(s) stated in the notice of deficiency will be further extended by the number of days the assessment was previously prohibited, plus 60 days. A final adverse determination subject to declaratory judgment under sections

7428, 7476, or 7477 of the Internal Revenue Code will not terminate this agreement.

(2) This agreement ends on the earlier of the above expiration date or the assessment date of an increase in the above tax that reflects the final determination of tax and the final administrative appeals consideration. An assessment for one period covered by this agreement will not end this agreement for any other period it covers. Some assessments do not reflect a final determination and appeals consideration and therefore will not terminate the agreement before the expiration date. Examples are assessments of: (a) tax under a partial agreement; (b) tax in jeopardy; (c) tax to correct mathematical or clerical errors; (d) tax reported on amended returns; and (e) advance payments. In addition, unassessed payments, such as amounts treated by the Service as cash bonds and advance payments not assessed by the Service, will not terminate this agreement before the expiration. This agreement ends on the date determined in (1) above regardless of any assessment for any period includible in a report to the Joint Committee on Taxation submitted under section 6405 of the Internal Revenue Code.

(3) This agreement will not reduce the period of time otherwise provided by law for making such assessment.

(4) The taxpayer(s) may file a claim for credit or refund and the Service may credit or refund the tax within 6 (six) months after this agreement ends.

During October 1980 and September 1980, the Forms 872-A were executed for petitioners' 1973 and 1974 taxable years, respectively. On December 31, 1981, respondent mailed duplicate original notices, of deficiency to petitioners' former addresses at Oak Ridge, Tennessee, and Seattle, Washington. Petitioners did not receive either of the duplicate original notices, and on May 24, 1982, respondent assessed the full amount of the 1973 and 1974 income tax deficiencies. Petitioners paid the assessed tax and interest late in 1982 and early in 1983. About 2½ years later, during June 1984, petitioners petitioned to this Court and then moved for a dismissal for lack of jurisdiction on the ground that the December 31, 1981, notice was not sent to their "last known address" in accord with section 6212(b)(1).[1] Respondent, by a September 12, 1984, notice, advised of no objection to our granting petitioners' motion to dismiss.[2]

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[1] All statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] It is clear that respondent was aware of petitioners' then current Alamo, California, address when the 1981 notices of deficiency were sent to petitioners' former addresses. The 1981 notices were returned to respondent with the notations: "Moved, Not Forwarded" and "Moved Left No Address."

On November 9, 1984, we ordered the dismissal of docket No. 17824-84 due to respondent's failure to mail a notice of deficiency to petitioners' last known address.

Following the dismissal of docket No. 17824-84 petitioners, on September 16, 1985, mailed a Notice of Termination of Special Consent to Extend the Time to Assess Tax, Form 872-T (rev. August 1984), to respondent concerning the 1973 and 1974 taxable years. The text of Form 872-T, following identifying information including the taxable years involved, reads:

> Under the agreement dated _______, between the above taxpayer(s) and the Internal Revenue Service, this form is written notification of termination of Form 872-A * * * for the kind of tax and tax period(s) indicated above.

Petitioners added the following language to the Form 872-T:

> This Notice of Termination is filed without waiver of the taxpayers' position that the time to assess tax for the years in question has expired, based on the Service's mailing of a notice of deficiency on December 31, 1981.

On November 25, 1985, respondent refunded all payments of the 1973 and 1974 assessed and collected deficiencies, plus interest, to petitioners. On October 28, 1985, respondent mailed a notice of deficiency for 1973 and 1974 to petitioners' correct address. Petitioners initiated this case by filing a timely petition which respondent answered. For a second time, petitioners have moved to dismiss the 1973 and 1974 taxable years, due to lack of jurisdiction. On this occasion, however, petitioners contend that respondent's notice of deficiency (dated October 28, 1985) was not mailed prior to the expiration of the period within which tax for 1973 and 1974 could be assessed by respondent. Respondent's response to petitioners' motion is that the period for assessment is open because the 1980 Forms 872-A (open-ended consents) were never terminated and, if they were terminated, the holding in *Wallin v. Commissioner*, 744 F.2d 674 (9th Cir. 1984), revg. a Memorandum Opinion of this Court, confers jurisdiction upon this Court.

OPINION

The issues presented have not been addressed in a published opinion of this Court. We must first determine whether either the mailing of a notice of deficiency to the wrong address (not the "last known address") or the assessment of the tax based upon such a notice is sufficient to terminate an open-ended consent extending the assessment period.

Over the years, respondent has designed various forms by which the parties to a tax audit or controversy could agree to extend the statutory period for assessment under section 6501(c)(4). Initially, the agreements (Forms 872) were designed to extend the assessment period for a finite period. A second type of agreement (Form 872-A) was then designed to permit an open-ended extention or waiver of the statutory period until one of several enumerated events occurred. Respondent announced the new Form 872-A in Rev. Proc. 71-11, 1971-1 C.B. 678. Several administrative and legal problems were encountered with respect to the new Form 872-A.[3] In an attempt to remedy these shortcomings, respondent revised and announced new procedures with respect to Form 872-A in Rev. Proc. 79-22, 1979-1 C.B. 563. Under the revised Form 872-A (rev. July 1979) used in this case, the open-ended consent terminates after: (1) Respondent *receives* a Form 872-T; (2) respondent *mails* a Form 872-T; (3) respondent *mails* a notice of deficiency; or (4) the deficiency is finally *assessed*.

Respondent has structured the agreement, or consent, to his administrative advantage. The taxpayer may not terminate the consent without respondent's actual knowledge or at least receipt of a Form 872-T from the taxpayer.[4] On the other hand, respondent may terminate by simply mailing either a notice of deficiency or a Form 872-T. It is clear that there is no express requirement that a taxpayer receive the Form 872-T or notice of deficiency for the consent to be terminated. The parties herein have acted in a somewhat

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[3] In *Johnson v. Commissioner*, 68 T.C. 637 (1977), we held correspondence between the appellate division and the taxpayer, advising that a notice of deficiency was to be sent, sufficient to terminate the Form 872-A agreement. The terms of the earlier version of Form 872-A did not specifically require the mailing of the notice.

[4] In addition to the receipt requirement, taxpayers are also required to use the form provided by respondent, Form 872-T. See *Grunwald v. Commissioner*, 86 T.C. 85, 89 (1986).

unorthodox manner to avail themselves of benefits th
perceive to exist in respondent's revised procedures. Pe
tioners paid the tax and waited several years to air th
defense to the assessment.[5] Petitioners then tested respo
dent's mettle by sending a protective Form 872-T. Respo
dent answered by refunding the tax payments and mailing
new notice of deficiency to petitioners. Now petitioners a
us to dismiss for lack of jurisdiction due to responden
alleged inability to issue a notice of deficiency.[6]

Respondent's position is that the 1981 notice of deficien
was a "nullity." Respondent argues that a notice
deficiency must meet the statutory requirements of secti
6212 to effectively terminate a Form 872-A agreeme
Further, respondent argues that petitioners did not recei
actual notice of the 1981 notice of deficiency and could n
have relied upon it. Finally, respondent points out that "
order to terminate an 872-A, notice of one party's intent
terminate must be *communicated* to the other party." V
find respondent's position that the notice must be commu
cated to be somewhat of a paradox when considered
conjunction with the express terms of the Form 872-A a
the procedures outlined in Rev. Proc. 79-22, 1979-1 C.
563. There would also be a lack of continuity and reas
with the principle that a notice of deficiency may satis
the requirements of sections 6212 and 6213 even though
is never received at the "last known address"[7] (*Luhring*
Glotzbach, 304 F.2d 556 (4th Cir. 1962)), or imprope
addressed without chance of delivery and notice, but t
taxpayer becomes aware of it and timely petitions th

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[5] Petitioners could have filed a complaint in the U.S. District Court or Claims Court seek
a refund of the 1973 and 1974 income tax deficiencies they had paid. Instead, they wai
several years to file a petition in our Court and to request its dismissal for lack of jurisdicti
The alternative selected by petitioners did not insure the return of the taxes paid. Because
3-year statute had, under petitioners' theory, expired during 1982, we presume that petition
may not have been aware of their statute of limitation defense at the time they paid the
during the latter part of 1982 and early part of 1983.

[6] Although petitioners have couched their motion as one to dismiss for lack of jurisdiction
more properly goes to the merits of these taxable years. If we find that the statutory pe
for assessment and collection has expired, either the second notice is ineffective or petition
have a complete defense to any determination, assessment, or collection of tax for their 1
and 1974 taxable years. This motion could be and is alternatively considered one for summ
judgment under Rule 121.

[7] It appears that respondent designed the 1979 Form 872-A, in part, for his o
administrative convenience and to comport with the statutory requirement of mailing, wh
contains no requirement of receipt by the taxpayer.

Court (*Clodfelter v. Commissioner*, 527 F.2d 754, 757 (9th Cir. 1975), affg. 57 T.C. 102 (1971); *Goodman v. Commissioner*, 71 T.C. 974, 977-978 (1979)).

A consent to extend the period for assessment is essentially a unilateral waiver of the taxpayer's defense and it is not a contract. *Stange v. United States*, 282 U.S. 270 (1931); *Piarulle v. Commissioner*, 80 T.C. 1035, 1042 (1983). "Contract principles are significant, however, because section 6501(c)(4) requires that the parties reach a written agreement as to the extension. The term 'agreement' means a manifestation of mutual assent. S. Williston, Contracts 6 (3d ed. 1957)." *Piarulle v. Commissioner, supra* at 1042.

Respondent has attempted to interpret and characterize the language and meaning of the terms in the Form 872-A to meet his current predicament. It is clear to us that respondent placed a higher standard on the taxpayers than on himself by requiring actual receipt by respondent before a Form 872-A consent may be terminated by the taxpayer. It is also clear that the terminology used by respondent did not require receipt by a taxpayer of respondent's Form 872-T or notice of deficiency. Respondent's argument that a notice of deficiency that does not in every respect comply with section 6212 is a "nullity," ignores respondent's ability to terminate a Form 872-A consent by simply mailing a Form 872-T to the taxpayer. There is no corresponding statutory requirement that the address be correct on a Form 872-T. If respondent had wished to use an actual notice or "communication" standard, he should have incorporated it in the terms of the revised consent form.[8] On the other hand, we believe that an improperly addressed notice of deficiency or Form 872-T which does not have the potential to advise a taxpayer of the intended termination by respondent, would not suffice to terminate the parties' agreement. This rationale is in line with the case law regarding notices of deficiency. In this case, however, petitioners became aware of the undelivered notices of deficiency sometime between the mailing of the 1981 notices and the payment of the tax during 1982 and 1983. Considering those two events together (mailing of the notices and petitioners' later knowledge of same), the purpose of the mailing of the notice and its intended effect upon the Form 872-A consent have been achieved. We believe this to be a fair reading of the parties' agreement, ostensibly insuring some possibility of success in notification of termination. Furthermore, this result is conceptually analogous to the case law governing notices of deficiency which may provide parallel procedures and results regarding the effect of notices of deficiency upon the parties. See *Clodfelter v. Commissioner, supra*, and *Goodman v. Commissioner, supra.*

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[8] Nothing herein is intended to preclude respondent from revising the terms of Form 872-A.

It is fundamental that doubtful language in a contract should be interpreted against the party who has selected the language. *Moulor v. American Life Insurance Co.*, 111 U.S. 335 (1884); *In re Rule's Estate*, 25 Cal. 2d 1, 152 P.2d 1003, 1009 (1944). This principle is especially pertinent here where respondent is asking us to ignore the literal terms of the consent in a manner favoring himself. The essential question we seek to answer is not whether the 1981 notices are notices of deficiency within the meaning of section 6212,[9] but whether respondent intended to and did terminate the effect of the Form 872-A by mailing a notice of deficiency, mailing a Form 872-T, or assessing the deficiency in dispute.

Respondent offers some case precedents which he believes to be "similar or identical" to this case. In *Commissioner v. DeLeve*, 748 F.2d 465 (8th Cir. 1984), the parties had entered into a Form 872-A agreement. Thereafter, the taxpayer voluntarily petitioned in bankruptcy. Respondent mailed a notice of deficiency after the commencement of the bankruptcy proceeding. Several years later, the taxpayers moved for summary judgment in the Bankruptcy Court on the ground that the notice of deficiency terminated the Form 872-A agreement and that, accordingly, the statutory period for assessment had expired. The Eighth Circuit Court of Appeals affirmed the District Court's holding that section 6871(a) permits immediate assessment without resort to section 6213(a) deficiency procedures and that the notice of deficiency was a nullity. *Commissioner v. DeLeve*,

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[9] We have already decided, based upon petitioners' motion and respondent's notice of no-objection that the 1981 notices of deficiency did not meet the requirements of sec. 6212. That question concerned our jurisdiction and respondent's ability to assess without further "deficiency procedures."

supra. The rationale underlying the Eighth Circuit's holding is that the deficiency procedure is obviated and respondent is statutorily unable to issue a notice of deficiency.

The *DeLeve* rationale is dependent upon the intervening bankruptcy provisions and the practical or actual incapacity of respondent to issue a notice of deficiency under section 6871. Stated another way, the attempt to issue or mail a notice of deficiency where respondent has the authority to immediately assess the tax and where this Court could not acquire jurisdiction or consider the merits is of no effect or could be considered a "nullity."

When respondent mailed the 1981 notices of deficiency in this case, there was no such impediment as existed in *DeLeve*. Although the 1981 notices did not meet the "last known address" requirement of section 6212(b), they were not a "nullity" for purposes of the Form 872-A agreement, but they were notices of deficiency with statutory defects.[10] Indeed, respondent assessed and collected the income tax deficiencies determined in the 1981 notices.[11]

In *Lefebvre v. Commissioner*, T.C. Memo. 1984-202, affd. per curiam 758 F.2d 1340 (9th Cir. 1985), we considered whether the Form 872-A had been properly executed. Respondent contends that the parties' failure in that case to contest a similar intervening notice with a wrong address provides precedential value to our Memorandum Opinion which is germane to this case. We strongly disagree and find that *Lefebvre v. Commissioner, supra*, is not on point.[12] Because we have found that the notices of deficiency under the circumstances of this case terminated the parties' Form 872-A consent, respondent has asked us, in the alternative, to find that we nevertheless have jurisdiction over the parties and the subject matter under the holding of *Wallin v. Commissioner*, 744 F.2d 674 (9th Cir. 1984), revg. a Memorandum Opinion of this Court. Respondent's position and the rule of law given to us in *Wallin v. Commissioner, supra*, are not readily evident without an understanding of the factual background and the legal history.

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[10] Although we have held that notices of deficiency not mailed to a taxpayer's last known address are a "nullity," we have so held in connection with the notices' compliance with sec. 6212(b). *Reddock v. Commissioner*, 72 T.C. 21 (1979). The use of the word "nullity" in those cases must be factored in with the holding in *Clodfelter v. Commissioner*, 527 F.2d 754 (9th Cir. 1975), affg. 57 T.C. 102 (1971), where the defect is cured by actual notice and the successful petitioning of our jurisdiction.

[11] When respondent assessed and collected the 1973 and 1974 income tax deficiencies based upon the defective notice, from which petitioners were unable to petition, petitioners were or became possessed of an affirmative statute of limitation defense. If in that situation respondent was not aware of the defect in the notice or petitioners did not raise the affirmative defense, the tax and interest would not be returned to petitioners. Accordingly, an argument could be made that the assessment of the 1973 and 1974 tax deficiencies during 1982 was an event described in the Form 872-A which, upon communication to petitioners of the fact of assessment, could have terminated the agreement. Respondent has argued that an assessment based upon a notice which is a "nullity" is not an assessment within the meaning of the agreement. Respondent's position is not without merit, but due to our holding that petitioners' actual knowledge of the notice acquired during the collection process cured the address defect, we need not reach respondent's position.

The *Wallin* case presents a common fact pattern where taxpayers seek to "justify" their otherwise untimely petitions by showing that respondent did not issue or mail a notice of deficiency in compliance with sections 6212 and 6213. Eve Watson (Eve) had filed her 1977 Federal individual income tax return reflecting her social security number and Alaska address. Within the next several months she moved twice, took up residence in Washington, and married Robert Wallin. Eve filed a joint return for 1978 and 1979 reflecting a Washington address and using the name "Wallin." Eve's social security number was reflected in the "lower box" provided for the spouse of the first named taxpayer. Eve did not separately notify respondent of her change of name or address. In connection with the 1980 audit of Eve's 1977 return, respondent's agent attempted to contact Eve at her Alaska address, but correspondence was returned by the Post Office as "undeliverable" and there was no forwarding address. Respondent's agent checked State of Alaska motor vehicle records and Internal Revenue Service Center records for Alaska by name and social security number and was not able to find a more current address. It was further determined that there was no record of Eve's filing a 1978 or 1979 Federal return as a resident of Alaska. The notice of deficiency for Eve's 1977 taxable year was sent to her Alaska address, and it was returned to respondent marked "unclaimed." Shortly thereafter respondent assessed the 1977 income tax deficiency and it was assigned to an officer for collection. The collection officer was not able to determine Eve's whereabouts from the Internal Revenue Service Center records because the spousal social security number was not searched. The collection office finally located Eve by means of an inquiry of the Social Security Administration. Eve was contacted concerning her 1977 taxable year (and with regard to the fact that a notice of deficiency had been sent to her Alaska address) by means of a certified letter mailed to her on September 11, 1981. Eve's petition was received by this Court on October 13, 1981.

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[12] Respondent also directed our attention to an unpublished Memorandum Sur Order of this Court. Such memoranda by their unpublished status bespeak their lack of precedential value beyond the litigants to which they are addressed.

In our Memorandum Opinion (T.C. Memo. 1983-52) we found Eve's petition to be untimely, because it was not filed within 90 days of respondent's mailing of the notice of deficiency. As a premise to finding the petition was filed untimely, we first found that respondent's notice to the taxpayer was mailed to her "last known address." Generally, the address reflected on a return is the "last known address" unless the taxpayer sends a clear and concise notification to respondent directing a change of address. *Alta Sierra Vista, Inc. v. Commissioner*, 62 T.C. 367, 374-375 (1974), affd. without published opinion 538 F.2d 334 (9th Cir. 1976); *Looper v. Commissioner*, 73 T.C. 690, 696-697 (1980). Respondent is bound to exercise reasonable diligence in ascertaining a taxpayer's correct address. *Maxfield v. Commissioner*, 153 F.2d 325, 326 (9th Cir. 1946); *Alta Sierra Vista, Inc. v. Commissioner, supra* at 374. The standards or duties placed upon taxpayers and respondent usually meet or intersect at some point. It is at that point that the responsibility shifts from the taxpayer to respondent. The case law has held taxpayers to a higher standard than respondent. "Administrative realities demand that the burden fall upon the taxpayer to keep the Commissioner informed as to his proper address." *Alta Sierra Vista, Inc. v. Commissioner, supra* at 374.

In those instances where a taxpayer has made no specific attempt to communicate a new address (this assumes that respondent has become aware that the address reflected on the return is no longer correct), respondent is generally entitled to rely on the address shown on the return. Respondent should also be aware of address information acquired in the district where the return was filed (i.e., *Keeton v. Commissioner*, 74 T.C. 377 (1980)). The Nint Circuit has placed a higher standard of responsibility upo respondent. In *Cool Fuel, Inc. v. Connett*, 685 F.2d 30 312-313 (9th Cir. 1982), the circuit affirmed the Distric Court's holding that would require the Commissioner t search beyond the district in which the subject return wa filed. See also *Welch v. Schweitzer*, 106 F.2d 885 (9th Ci 1939). In addition to broadening the geographical scope, th Ninth Circuit has placed a more rigorous burden o respondent by requiring a thorough search of his record even where a taxpayer has not directly communicated an change of address.

Without direct notification of Eve's move and nam change, we held that respondent's district-wide search wa sufficient to satisfy the "reasonable diligence" standar The Ninth Circuit reversed, holding that respondent did no exercise diligence in Eve's case because he did not perfor a computer search for social security numbers in both "th primary taxpayer's box and the "spousal taxpayer's box. In remanding Eve's case to our Court, the Circuit Cour instructed us "to file, as timely," Eve's petition concernin her 1977 tax year. No supporting rationale or analysis o section 6212 or 6213 was provided by the Circuit Cour regarding its instruction to treat the petition as timely.[1

Section 6212 permits the filing of a petition within 9 days of the mailing of a notice of deficiency. The Circui Court's opinion varies from the statutory language in tha it would appear to permit the filing of a petition at an time within 90 days of the time a taxpayer acquire knowledge of a notice of deficiency which was not addresse to the taxpayer's last known address.[14] Appeal of this ca

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[13] Eve's petition was received and filed more than 90 days after respondent's attempt issuance and mailing of a notice of deficiency for 1977 and about 30 days after her ac knowledge of the notice.

[14] The reasoning of the Ninth Circuit's holding, when followed to a logical conclusion, procedurally troublesome. It may result in litigation long after tax records and witnesses available. There would be no statutory limit upon the parties and it may promote uncertai We commend the Circuit Court's concern for equity and fairness in providing a forum with payment of the tax, but the holding appears to confer jurisdiction upon this Court which not have been statutorily mandated. The jurisdiction of this Court was legislatively confe and has generally been narrowly construed. *Commissioner v. Gooch Milling & Elevator C* 320 U.S. 418 (1943). A valid petition is the basis of this Court's jurisdiction and to be val petition must be filed in response to a valid notice of deficiency. *Stamm International Corp. Commissioner*, 84 T.C. 248, 252 (1985); *Midland Mortgage Co. v. Commissioner*, 73 T.C. (1980).

lies in the Ninth Circuit and we are bound to follow the holding in *Wallin v. Commissioner, supra. Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971).

The Ninth Circuit could have granted Eve Wallin's motion to dismiss[15] and respondent would have been barred from assessing or collecting a 1977 deficiency in income tax. The Circuit Court chose to place the parties in our Court on the merits without providing guidelines or rationale. Respondent argues that "the Ninth Circuit is concerned about petitioners who may not have a forum to contest the merits of the * * * notice and * * * the loss to the government fisc that a dismissal would bring." Respondent also speculates that the Circuit Court did not wish to generate a windfall to Eve Wallin for nothing more than a "clerical error." Respondent obviously believes he is or should be a beneficiary of the type of relief granted to Eve Wallin. We disagree.

The Circuit Court's opinion appears to be grounded on equitable principles. We assume that the Circuit Court was more concerned with the taxpayer's ability to obtain a hearing on the merits without first paying the tax, rather than the "fisc." This assumption is strongly suggested factually in *Wallin v. Commissioner, supra*, where the Circuit Court held it was respondent's failure to exercise reasonable diligence in seeking out the correct address. We do not feel constrained to allow respondent to benefit by his lack of diligence in these circumstances, where petitioners do not wish a trial on the substantive merits, but are seeking to fend off respondent on the theory that the statutory period for assessment has expired.[16]

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[15] In *Wallin v. Commissioner*, 744 F.2d 674 (9th Cir. 1984), revg. a Memorandum Opinion of this Court, the taxpayer and respondent filed cross-motions for dismissal due to lack of jurisdiction. The taxpayer contended that the notice of deficiency was invalid and the statutory period for assessment had run so that respondent had no capacity to issue a new notice or assess and collect the tax based upon the invalid notice. Respondent contended that the notice was valid and the petition was untimely permitting assessment and collection of the tax. Under respondent's contention, the taxpayer would have been able to contest the merits of her 1977 tax year by paying the tax and suing for a refund. Under the taxpayer's contention, the merits of the 1977 tax year would have been res judicata.

[16] A myriad of additional administrative and legal questions remain unanswered as a result of the Circuit Court's holding in *Wallin v. Commissioner, supra*, but need not be considered on these facts.

Since we hold that the statute of limitations on asses ment for 1973 and 1974 has expired, petitioners' motion fo summary judgment (see note 6 *supra*) is granted.

To reflect the foregoing,

An appropriate order will be entere

Reviewed by the Court.

STERRETT, CHABOT, NIMS, WHITAKER, SHIELDS HAMBLEN, CLAPP, JACOBS, WRIGHT, PARR, WILLIAMS and WELLS, *JJ.*, agree with the majority opinion.

COHEN, *J.*, agrees with the result only.

KÖRNER and SWIFT, *JJ.*, did not participate in th consideration of this case.

SIMPSON, *J.*, dissenting: I must disagree with th majority's interpretation of the extension agreement. M understanding of contract law is that the cardinal principl of interpretation is that the Court should attempt to giv effect to the intentions of the parties to the agreement, an I believe that the majority has lost sight of that objectiv 3 A. Corbin, Contracts, sec. 538 (Supps. 1960 & 1971); Restatement, Contracts 2d, sec. 202 (1979); 4 S. Willisto Contracts, sec. 601 (3d ed. 1961 & Cum. Supp. 1986 Additionally, in interpreting a contract, "technical term and words of art are given their technical meaning whe used in a transaction within their technical field," unles the parties have manifested a different intention. Restat ment, *supra* at sec. 202(3).

Section 6501 establishes the various statutes of limitatio on the time within which the Commissioner must ac However, a taxpayer and the Commissioner may agree t extend those times. Historically, an extension was for fixed period. Whether the parties were operating under th statutory limitations or under a limitation established by a extension agreement, the Commissioner knew when he ha to act—he knew that if he did not issue a notice deficiency and commence the tax collection procedures b the known date, he would forego his right to collect the ta

In this case, we have a new type of an extension agreement: under it, the extension continues indefinitely, but it can be terminated by either party. It can be terminated by either party giving notice of his intention to terminate, but if it is terminated in that manner, the Commissioner is given a period of time within which to issue his notice of deficiency and commence the tax collection procedures. To avoid the Commissioner's having to issue a notice of termination followed by a notice of deficiency, the agreement also provides that it can be terminated simply by the Commissioner's issuing a notice of deficiency. When the notice of deficiency is issued, both parties will then have their days in court to dispute the merits of the claimed deficiency.

The Court's interpretation of the agreement has undermined these arrangements. In the earlier case, the taxpayer asked the Court to set aside the assessment on the ground that the notice of deficiency was invalid, and the Court granted that request. Now the taxpayer asks the Court to hold that the notice of deficiency was effective to terminate the extension because he learned of it in 1982, and the Court is granting that request. As a result of these two decisions, the Court has construed the agreement so as to deprive the Commissioner of any right to come to Court to claim a deficiency, and to relieve the taxpayer from any claimed deficiency without his having to prove that he did not owe such deficiency.

Surely, no one can doubt that when the parties executed the extension, they contemplated that it could only be terminated by a Form 872-T or a notice of deficiency that would be effective under section 6213 to commence the tax collection procedures, or that would have been their contemplation if they had thought about the matter. Yet, as a result of this decision, it will be necessary for the Commissioner to revise his Form 872-A to make clear that the consent is terminated by a notice of deficiency that is effective under section 6213, but this taxpayer will enjoy the windfall of never having to prove that he did not owe the tax claimed by the Commissioner.

PARKER, *J.*, agrees with this dissent.

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ESTATE OF NONA H. BABBITT, DECEASED, PHYLLIS B. ANDERSON AND ALVIN E. BABBITT, INDEPENDENT EXECUTORS, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 36998-84. Filed December 4, 1986.

Decedent executed an instrument on Sept. 11, 1980, purporting to convey to each of her 16 children and grandchildren a $3,000 interest in her residence. Decedent died on Dec. 15, 1980. *Held*, assuming the Sept. 11, 1980, instrument conveyed valid interests in real property under Texas law, decedent transferred future rather than present interests, which did not qualify for the "annual exclusion" from the gift tax under sec. 2503(b), I.R.C. 1954, and were includable in her gross estate under sec. 2035(a), I.R.C. 1954, as transfers made within 3 years of decedent's death. *Held, further*, the value of decedent's residence included in her gross estate determined.

Al Schulman, for the petitioner.
David B. Mora, for the respondent.

FEATHERSTON, *Judge*: Respondent determined a deficiency in the amount of $45,557 in petitioner's estate tax. After concessions, the only issue for decision is whether decedent transferred during her lifetime 16 interests of $3,000 each in her residence to her 16 children and grandchildren which are includable in her gross estate under section 2035(a).[1]

FINDINGS OF FACT

Decedent Nona H. Babbitt (hereinafter decedent) died on December 15, 1980. The executors of her estate are Alvin E. Babbitt (Alvin) and Phyllis B. Anderson (Phyllis). At the time the petition was filed, Phyllis resided in Spring, Texas, and Alvin lived in Houston, Texas. Decedent's estate (petitioner) filed a Federal estate tax return with the Internal Revenue Service Center, Austin, Texas, on or about September 1, 1981.

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[1] All section references are to the Internal Revenue Code of 1954 as in effect on the date of decedent's death, unless otherwise noted.

Prior to August 1980, decedent owned and lived in a residence at 10026 Bob White, Houston, Texas (residence). On August 18, 1980, decedent was hospitalized and learned that she had terminal cancer. After staying at the hospital for 9 or 10 days, decedent moved in with Phyllis, her daughter, and lived in Phyllis' home until her death. Decedent removed most of her personal effects from the residence, but left the furniture in the house. She never returned to live in the residence.

Decedent paid the utilities and other expenses of the residence up to the date of her death. Decedent's Federal income tax return for 1980 reflects a deduction for property taxes for the calendar year 1980 paid by petitioner.

On or about September 1, 1980, the residence was offered for sale by decedent by placing a "for sale by owner" sign on the property. The residence was listed with a real estate agent on or about September 15, 1980. The residence was eventually sold on February 19, 1983, for $62,000.

On September 11, 1980, decedent, accompanied by Phyllis and Alvin, visited the office of Al Schulman (Schulman), a Houston attorney. On that day, decedent executed her last will and testament and an instrument purporting to transfer as a gift to each of 16 named individuals a $3,000 present interest in the residence (instrument).[2] Each of the 16 individuals named in the instrument was decedent's child or grandchild. The instrument was notarized but not recorded in county land records.

The document was kept at Schulman's office and not delivered to any of the 16 children and grandchildren. Phyllis and Alvin were told in Schulman's office that decedent had made her will and had executed a "deed of 16 $3,000 gifts." They were present when decedent requested that Schulman keep both her will and the instrument in his office.

None of the individuals named in the instrument took possession or control of the residence before decedent's death. Each of the 16 individuals named in the instrument received $3,000 in cash from decedent's estate and executed a document dated April 13, 1981, which purports to b release of their interests in the residence under the inst ment.

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[2] Six of the 16 gifts were designated as made under the Uniform Gift to Minors Act, Tex. Rev. Civ. Stat. Ann. art. 5923-101 (Vernon 1963), as amended by Acts 1975, 64th Leg., ch. 582, sec. 2, naming as custodians for the minor donees, Phyllis B. Anderson, Alvin E. Babbitt, and Ronald W. Babbitt.

Petitioner reported the value of the residence at the d of decedent's death at $75,000 on its estate tax return claimed a deduction of $48,000 for "Mortgages and Lien The parties agree that the value of the residence decedent's date of death was $62,259.[3] Petitioner n contends that its claimed deduction for mortgages and li was inadvertent.[4]

OPINION

1. *Includability of the $3,000 Interests in Decedent's Esta*

The parties debate at length the question whether instrument executed by decedent on September 11, 19 transferred interests in real property under Texas l Citing *Tennant v. Dunn*, 130 Tex. 285, 110 S.W.2d 53, (1937), and *Standard Oil Co. of Texas v. Marshall*, 265 F 46, 53 (5th Cir. 1959), which hold that an oil payment is interest in real property, petitioner analogizes the inst ment to the conveyance of an oil payment and conte that the instrument conveyed 16 individual present in ests in decedent's property. On that ground, petitio maintains that decedent's gross estate does not include $48,000 which represents the total value of the 16 in vivos gifts of $3,000 each. Respondent argues, alternativ that (1) the instrument lacks the certainty required o valid deed under Texas law, (2) the instrument was inva for lack of delivery under Texas law, and (3) if the transf were complete, they were gifts of future interests m within 3 years of decedent's death and, therefore, includa in decedent's gross estate under section 2035(a).

The parties agree that the Texas courts, apart from oil and gas cases, have not answered the precise quest whether a purported conveyance of an interest in l measured by a dollar amount is sufficient to transfer interest in real property. Our own research has disclosed definitive answer by the Texas courts. We find it unnecessary, however, to answer the question here.

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[3] The parties have stipulated that petitioner is entitled to a deduction of $4,729 for the of selling the property.

[4] No deduction would be allowable for the transfers on the theory that they created c against the estate because the donees gave no consideration therefor. Sec. 2053(c)(1)(A).

Assuming, without deciding, that the September 11, 1980, instrument transferred real property interests to decedent's children and grandchildren, the transfers were made within 3 years of the date of decedent's death on December 15, 1980. Section 2035(a)[5] provides that "Except as provided in subsection (b)" of that section, the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent made a transfer "during the 3-year period ending on the date of the decedent's death." The 16 transfers, made only about 3 months before decedent died, are thus includable in decedent's gross estate unless they fall within the exception provided in section 2035(b).

Insofar as it is here applicable, section 2035(b) provides that the foregoing 3-year general rule does not apply to any gift to a donee if the decedent was not required by section 6019 to file a gift tax return for such year with respect to gifts to that donee. Section 6019(a)[6] provides that any individual who in any calendar quarter makes any transfer by gift, other than a transfer which under section 2503(b) is not to be included in the total amount of gifts for such quarter shall make a gift tax return. Section 2503(b)[7] provides, in part, that in the case of "gifts (other than gifts of future interests in property)" made to any person by the donor, the first $3,000 of such gifts to such person shall not

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[5] SEC. 2035. ADJUSTMENTS FOR GIFTS MADE WITHIN 3 YEARS OF DECEDENT'S DEATH.

(a) Inclusion of Gifts Made by Decedent.—Except as provided in subsection (b), the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, during the 3-year period ending on the date of the decedent's death.

[6] SEC. 6019. GIFT TAX RETURNS.

(a) In General.—Any individual who in any calendar quarter makes any transfers by gift (other than transfers which under section 2503(b) are not to be included in the total amount of gifts for such quarter and other than qualified charitable transfers) shall make a return for such quarter with respect to the gift tax imposed by subtitle B.

[7] SEC. 2503. TAXABLE GIFTS.

(b) In computing taxable gifts for the calendar quarter, in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year 1971 and subsequent calendar years, $3,000 of such gifts to such person less the aggregate of the amounts of such gifts to such person during all preceding calendar quarters of the calendar year shall not, for purposes of subsection (a), be included in the total amount of gifts made during such quarter. * * *

be included in the total amount of gifts made during
calendar quarter (annual exclusion).

The question, then, is whether, assuming that decedent
September 11, 1980, made a valid transfer of interests
her residence to her children and grandchildren, the int
ests so transferred were present or future interests. If
find that decedent's gifts of $3,000 interests were gifts
future rather than present interests, the gifts would
qualify for the annual exclusion and, because they w
made within 3 years before her death, the gifts would
includable in decedent's gross estate under section 2035
If the gifts were of present interests, they would qualify
the annual exclusion and would not be includable
decedent's estate.

The regulations under section 2503 define future intere
as follows (sec. 25.2503-3(a), Estate and Gift Tax Regs.):

> "Future interests" is a legal term, and includes reversions, remaind
> and other interests or estates, whether vested or contingent, and whet
> or not supported by a particular interest or estate, which are limited
> commence in use, possession or enjoyment at some future date
> time. * * *

The regulation further provides (sec. 25.2503-3(b), Est
and Gift Tax Regs.):

> An unrestricted right to the immediate use, possession, or enjoym
> of property or the income from property (such as a life estate or te
> certain) is a present interest in property. * * *

This definition has been adopted by the Supreme Cou
Commissioner v. Disston, 325 U.S. 442, 446 (1945). T
present right to use, possess, or enjoy the property, not t
mere vesting of a legal right or title to the propert
identifies a present interest for purposes of the ann
exclusion from the gift tax. *Fondren v. Commissioner*, 3
U.S. 18, 20-21 (1945); *Hamilton v. United States*, 553 F.
1216, 1218 (9th Cir. 1977). "The question is of time,
when title vests, but when enjoyment begins." *Fondren*
Commissioner, *supra* at 20.

Under this standard, the interests decedent conveyed
her 16 children and grandchildren were future intere
within the meaning of section 2503(b). Nothing in the rec

reveals an intention on decedent's part that the 16 donees have possession or other present use of the residence. None of the 16 individuals occupied or attempted to occupy the residence before it was sold. There is no evidence that any donee other than Phyllis and Alvin was even aware that the gift had been made. Indeed, petitioner states in his brief that both Phyllis and Alvin were seeking to assist in selling the residence, and "it was contemplated that the proceeds of the sale would be used to redeem and obtain releases of the sixteen $3,000.00 gifts and that the balance of the money would be paid to the Decedent."[8] The inference is that decedent intended merely to convey 16 $3,000 interests in the proceeds from the sale of her residence. Support for this inference is found in the retention of the instrument in Schulman's office and the failure to record it in the appropriate land records.

To an owner of an interest in proceeds from a future sale, enjoyment of the property is postponed until the property is sold. It is the postponement of the enjoyment of the gift that brands it as a future interest. *Fondren v. Commissioner*, 324 U.S. at 20-21. "If the donee does not have the right to immediate possession or enjoyment, his interest is a future interest even though possession or enjoyment is deferred for only a short time." *Hamilton v. United States*, 553 F.2d at 1218.

Again assuming the validity of petitioner's analogy of the 16 $3,000 interests in decedent's residence to oil payments under Texas law, our conclusion that the $3,000 interests were future interests under section 2503(b) is confirmed by the character of an oil payment. According to the Texas Supreme Court, an oil payment is a real property interest but it is not a possessory interest under Texas law; rather it is an incorporeal hereditament[9]—an entitlement to a share of the oil or its proceeds if, as, and when oil is produced. *Tennant v. Dunn*, 130 Tex. 285, 110 S.W.2d 53 (1937); *State v. Quintana Petroleum Co.*, 134 Tex. 179, 133

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[8] Petitioner's trial counsel prepared the Sept. 11, 1980, instrument. In his opening statement, he explained that the plan was for decedent to sell the house as soon as possible, for each of the 16 donees to obtain his or her share of the proceeds, and for decedent to receive the remainder.

[9] An "incorporeal hereditament" is defined as "anything, the subject of property, which is inheritable and not tangible or visible." Black's Law Dictionary (5th ed. 1979).

S.W.2d 112 (1939).[10] As stated in *Belgam Oil Co. v. We Franklin Petroleum Corp.*, 209 S.W.2d 376, 380 (Tex. C App. 1948), "owners of the overriding royalties [which a similar to oil payments] do not have the right of possessi or the right to share in the possession under the lease Contrary to one of petitioner's arguments, the 16 done could not have maintained a partition suit because owne of nonpossessory interests in Texas real property have n right to demand partition of the property. *Douglas v Butcher* 272 S.W.2d 553, 555 (Tex. Civ. App. 1954); s Texas Prop. Code Ann. sec. 23.001 (Vernon 1984); *Standa Oil Co. of Texas v. Marshall*, 265 F.2d 46, 54 (5th Cir. 195

Because the sixteen $3,000 interests in decedent's re dence did not entitle the children and grandchildren t immediate use, possession, or enjoyment of the propert such interests were future interests within the meaning o section 2503(b). Sec. 25.2503-3, Estate and Gift Tax Reg Even if valid interests in real property, they are nonethele includable in decedent's gross estate under section 2035(a).

2. *Valuation of Decedent's Residence*

The parties have stipulated that the fair market value o decedent's residence on her date of death was $62,25

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[10] The three most commonly used terms to describe partial interests in oil and gas prope were defined by the Texas Court of Appeals as follows (*Knight v. Chicago Corp.*, 183 S.W 666, 670 (Tex. Civ. App. 1944), affd. 144 Tex. 98, 188 S.W.2d 564 (1945)):

> "We think the terms undivided interest, overriding royalties and oil payments have cert well defined meanings in Texas. All three types of interest are carved out of and constitut part of the working interest created by an oil and gas lease. An overriding royalty is a cert percentage of the working interest which as between the lessee and the assignee is not charg with the cost of development or production. The oil payment is similar to the overrid royalty, except that the interest of the assignee ceases upon his receiving a certain amount money or value out of oil or gas produced from a certain percentage of the working inte The interest commonly spoken of as an "undivided interest" is an undivided percentage of t working interest, which differs from the oil payment or the overriding royalty in that i chargeable with its pro tanto share of the cost of development and production."

[11] As stated in note 2 *supra*, 6 of the 16 gifts were made to minors. Sec. 2503(c) provid "safe harbor" rule for future interest gifts to minors. See *Herr v. Commissioner*, 35 T.C. (1961), affd. 303 F.2d 780 (3d Cir. 1962). Under that rule no part of a gift to an individual has not attained the age of 21 years shall be considered a gift of a future interest for purp of sec. 2503(b) if the property and the income therefrom "may be expended by, or for t benefit of, the donee before his attaining the age of 21 years" and meets certain requirements. For the reasons discussed in the text, the gifts of future interests in this could not be expended until decedent's residence was sold and that could have occurred the minors had reached 21 years of age; therefore, the gifts did not meet the requirement sec. 2503(c). Although the Sept. 11, 1980, instrument designates a custodian for each of t gifts to the six minors under the Uniform Gifts to Minors Act, such designations do not b the gifts within sec. 2503(c), and they are includable in decedent's gross estate under 2035(a). See generally Rev. Rul. 59-357, 1959-2 C.B. 212.

Because we have concluded that the sixteen $3,000 gifts were, at best, transfers of future interests made within 3 years of decedent's death, the value of those transfers, as well as the value of the interest decedent retained, is included in decedent's gross estate under section 2035(a). Accordingly, the full $62,259 is includable in her gross estate.

Petitioner first contends that the value of decedent's residence included in her gross estate should be discounted because decedent transferred to her children and grandchildren fractional interests in the property, and all of the fractional interests, even if includable in decedent's gross estate, have less value than an entire undivided interest, relying on *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982). See also *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981). In the *Propstra* case, on a motion for summary judgment, the court found sufficient evidence that the value of an undivided fractional interest in real property included in the gross estate was less than a proportionate share of the fair market value of the whole. 680 F.2d at 1253.

The *Propstra* case is inapposite to the instant circumstances. In this case, the entire value of decedent's residence, including the value of the conveyances made within 3 years of decedent's death and brought back into her gross estate under section 2035(a), is included in her gross estate, not undivided fractional interests in the property. The purpose in valuing interests included in the gross estate under section 2035(a) at the date of decedent's death is to "make the transferred property cause the same tax result as if the decedent had kept it till he died instead of transferring it." *Humphrey's Estate v. Commissioner*, 162 F.2d 1, 2 (5th Cir. 1947). If decedent had retained the 16 $3,000 interests until she died, she would have owned a fee simple interest in her residence includable in her estate in its entirety under section 2033 at the stipulated fair market value of $62,259. The application of section 2035(a) to the instant facts should not change that tax result.

Petitioner next contends that the September 11, 1980, instrument created a cloud on the title of decedent's residence under Texas law for which the value of the

residence should be discounted. A cloud on title has be
defined as—

> a semblance of title, either legal or equitable, which is, in fact, invalid
> would be inequitable to enforce. In other words, a cloud on title is
> outstanding claim or encumbrance apparently valid, but is in fa
> invalid. * * *

Vanguard Equities, Inc. v. Sellers, 587 S.W.2d 521, 5
(Tex. Civ. App. 1979). We have assumed, for purposes
our analysis, that the instrument conveyed valid interests
property; therefore, the interests held by decedent's
children and grandchildren did not constitute a cloud
title under Texas law.

The standard applied for determining the fair mark
value of property interests for Federal estate tax purpos
is the price at which the property would change han
between a willing buyer and a willing seller, both wi
knowledge of the relevant facts. Sec. 20.2031-1(b), Esta
and Gift Tax Regs.; *Estate of Robinson v. Commission*
69 T.C. 222, 224 (1977). A willing buyer with knowledge
the relevant facts would be aware that the scheme he
involved was designed to pass $3,000 to each of the
individuals, that the instrument was not, and was n
intended to be, recorded, and that upon the purchase of t
property and distribution of the $3,000 gifts the
interests would vanish. The instrument would not, ther
fore, affect the value of the property.

Furthermore, petitioner has presented no expert tes
mony or any other evidence of valuation tending to sho
that a willing buyer would not purchase the residence at i
stipulated fair market value without a discount factor, n
is there any evidence as to what the discount should
even if one were appropriate.[12]

In summary, for purposes of our analysis, we ha
assumed that the September 11, 1980, instrument tran
ferred valid real property interests in decedent's residen
analogous to oil payment rights.[13] The interests creat
were future, rather than present, interests, not qualifyi
for the annual gift tax exclusion under section 2503(b).

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[12] See *Estate of Iacono v. Commissioner*, T.C. Memo. 1980-520.

[13] In assuming that the instrument transferred valid property interests under Texas law,
have not reached the merits of respondent's other arguments and we see no need to do so.

such, they are includable in decedent's estate under section 2035(a) as transfers made within 3 years of decedent's death. The value of decedent's residence is to be included in her gross estate at its stipulated fair market value of $62,259, not discounted by reason of the conveyances.

To reflect the foregoing,

Decision will be entered under Rule 155.

FRANK D. SPARKS AND EMILY J. SPARKS, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 42022-85. Filed December 8, 1986.

Ps are partners in the Project Omega Limited Partnership (the partnership). A portion of the deficiency determined by R for Ps' taxable year 1982 arises from adjustments to partnership items of the partnership. The offering memorandum, the limited partnership agreement of the partnership, and other documents state that the partnership will be formed upon termination of the offering which occurred in December of 1982. As of Sept. 3, 1982, the partnership's escrow account held $24,000, representing 4 units of participation (of a total of 80 units to be sold), and the general partner had begun to negotiate agreements on behalf of the partnership. The partnership opened an operating account on Dec. 31, 1982. *Held*, the subscriptions and the activities of the general partner prior to Sept. 4, 1982, were preoperating activities. *Held, further*, the partnership was formed when the partners acquired their capital interests in the partnership and not when they subscribed to the offering. *Held, further*, the partnership was formed subsequent to Sept. 3, 1982, and is, therefore, subject to the partnership audit and litigation provisions.

Robert E. Kovacevich, for the petitioners.

Eileen Kato Player, for the respondent.

WILLIAMS, *Judge*:[*] This case is before the Court on respondent's motion to sever from the petition the adjustments relating to the Project Omega Limited Partnership that resulted in a portion of the deficiency determined by respondent in Federal income tax for petitioners' taxable year 1982.

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[*] By order of the Chief Judge, this case was assigned to Judge Williams for decision and opinion.

The Commissioner determined deficiencies in petitioners' Federal income tax for the taxable years 1981 and 1982 and additions to tax as follows:[1]

		Additions to tax			
Year ended Dec. 31—	*Deficiency*	*Sec. 6651*[1]	*Sec. 6653(a)(1)*	*Sec. 6653(a)(2)*	*Sec. 6661*
1981	$46,707.84	$11,677	$2,832	50% of the interest due on $46,707.84	. . .
1982	30,595.50	2,486	1,535	50% of the interest due on $30,595.50	$3,060

The issue this Court must decide is whether the partnership audit and litigation provisions, viz, sections 6221 to 6233, apply to the adjustments determined by respondent in connection with petitioners' interest in the Project Omega Limited Partnership (Project Omega or the partnership) for petitioners' 1982 taxable year. The resolution of this issue turns on the date that Project Omega's 1982 taxable year commenced.

FINDINGS OF FACT

For purposes of this motion, all of the facts of this case have been stipulated and are so found. Petitioners resided at Oakland, California, at the time their petition was filed.

Respondent mailed a statutory notice of deficiency to petitioners on August 22, 1985, and in it disallowed petitioners' distributive share of the loss claimed by Project Omega for its taxable year ended December 31, 1982. Other adjustments unconnected with Project Omega also resulted in a deficiency determination for petitioners' taxable year 1982.

The offering memorandum for Project Omega dated May 25, 1982, states that the partnership's certificate of limited partnership will be filed upon termination of the offering pursuant to the Washington Limited Partnership Act.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, unless otherwise indicated.

A notice of claim of exemption (from State securities law registration requirements) was filed with the secretary of state of Washington on March 31, 1982, claiming that the partnership "will be formed upon completion of the offering." The certificate and agreement of limited partnership was filed with the secretary of state of Washington on December 30, 1982. Subscription agreements executed by those seeking to participate as limited partners were considered for acceptance by the general partner. The offering was scheduled to close on June 1, 1982, but was extended until December of 1982. The offering could be terminated if all of the 80 units offered were not subscribed to by the closing date. Upon termination, all funds and documents were returnable to the subscribers.

The Project Omega Limited Partnership Agreement, the notice of claim of exemption, and the offering memorandum of the partnership all state that the partnership would commence upon the closing of the offering. The partnership agreement provided that the interests of the partners vested upon the closing of the offering.

Charles Royer, president of Developmental Financial Systems, Inc., the general partner of the partnership, opened an escrow account at the Seattle First National Bank on August 10, 1982. Subscribers' capital contributions were deposited into this account. One unit of participation in the partnership required a contribution of capital of $6,000 and a pro rata assumption of the liability of the partnership in the amount of $19,000. The offering was approved by the State of Washington on April 27, 1982. The balance in the escrow account was $24,000 as of September 3, 1982. The account designated as the operating bank account of the partnership was opened at the Seattle First National Bank on December 31, 1982.

The Federal partnership information return (Form 1065) for the partnership's taxable year ended December 31, 1982, filed on March 13, 1983, stated that it was actively operated for 1 month in 1982. The date the business was started was not indicated on the return. However, the partnership filed an amended return on March 31, 1984, on which it stated that the business was actively operated for 12 months in 1982, and was started on January 1 of that

year. There has been no unanimous consent by Proj
Omega and the partners of Project Omega to be subject
the partnership audit and litigation provisions.

OPINION

In opposing respondent's motion to sever, petition
argue that the taxable year of Project Omega commen
prior to September 4, 1982, and therefore, absent un
mous consent to be subject to the partnership audit
litigation procedures (sec. 6221 et seq.), those procedures
not apply. Petitioners also argue that severance of the it
at issue herein is inconvenient and uneconomical for
parties and for the Court. Respondent counters that
partnership was formed after September 3, 1982,
therefore, its 1982 taxable year commenced after Septem
3, 1982, and consequently, application of the partners
audit and litigation procedures to Project Omega is man
tory. The result of applying those procedures is that
Court lacks jurisdiction in this case over that portion of
deficiency arising out of adjustments for "partners
items" within the meaning of section 6231(a)(3). *Maxwel*
Commissioner, 87 T.C. 783 (1986).

The date on which Project Omega's 1982 taxable
commenced is the date it was formed. Although determin
when a partnership is formed is a question of fact,
parties have stipulated sufficient facts to enable us
determine the date of formation without a hearing.

For Federal tax purposes, "partnership" is defined
including "a syndicate, group, pool, joint venture or ot
unincorporated organization through or by means of wh
any business, financial operation, or venture is carried
and which is not, within the meaning of this title [subti
a corporation or a trust or estate." Sec. 761(a). A part
ship is formed when the parties to a venture join toget
capital or services with the intent of conducting prese
an enterprise or business.[2] *Commissioner v. Tower*,
U.S. 280 (1946).

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[2] The elements required of a venture to qualify as a partnership, e.g., the sharing of p
are not at issue in this case. See *Commissioner v. Culbertson*, 337 U.S. 733 (1949). Rath
purposes of this motion the parties assumed that the venture, once formed, was a partn
There is nothing in the record to suggest that their assumption is erroneous.

The partnership is deemed to have been formed as of the date on which the first parties to the venture acquired their respective capital interests in the partnership. *Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939, 948 (1980), affd. 703 F.2d 485 (10th Cir. 1983). Each party must contribute either capital or services to the partnership to qualify as a partner in the venture. *Commissioner v. Culbertson*, 337 U.S. 733 (1949).

The agreement, the offering memorandum, and the notice of claim of exemption state uniformly that the partnership would be formed on the completion of the offering. The parties agree that the offering was not closed until December of 1982. The agreement states further that the respective interests of the partners would vest only upon the completion of the offering. See *Hensel Phelps Construction Co. v. Commissioner, supra*. In fact, the subscription amounts were held in escrow until December 31, 1982, when the capital contributions of the subscribers were transferred to an operating account. The documents reflect the intent of the parties to form the partnership in December of 1982. For the foregoing reasons, we conclude that for Federal tax purposes the partnership was formed subsequent to September 3, 1982.

Petitioners argue that the partnership was formed de facto prior to September 4, 1982, because the general partner of Project Omega incurred expenses, commenced negotiation of agreements on behalf of the partnership, and obtained some subscriptions prior to September 4, 1982. Further, petitioners argue that the partnership's amended return indicates that its operations commenced on January 1, 1982. We find petitioners' arguments unpersuasive. The solicitation of capital from prospective partners does not create a partnership. The record reflects that prospective partners were entitled to a refund of their contribution if the offering was aborted. Moreover, until the partnership's certificate of limited partnership was filed, the prospective partners were not liable for project omega's liabilities. Similarly, the general partner's commencement of negotiations with third parties on behalf of the partnership to be formed does not create the partnership; rather this activity is evidence only of an intent to form a partnership in the future. See *Voyles v. Murray*, 297 F. Supp. 1288 (N.D. Te 1969).

The Washington State cases relied on by petitioners t argue that a de facto general partnership existed are readil distinguishable—neither the level of activity nor the kind o activity in Project Omega approaches the business co ducted in *Molander v. Raugust-Mathwig, Inc.*, 44 Wash App. 53 (1986), or in *Dwinell's Central Neon v. Cosmopol tan Chinook Hotel*, 21 Wash. App. 929, 587 P.2d 191 (1978 further, in this case there simply was not the agreement t form a partnership prior to the closing of the offering.

The expenses incurred, subscriptions obtained, and negotiations conducted all represent preoperating activities. N capital interest vested in any partner prior to the closing o the offering. We conclude that the factors cited by petitio ers do not evidence the formation of a partnership prior t September 3, 1982.

Since the partnership was formed subsequent to Septen ber 3, 1982, the partnership audit and litigation provision of subchapter 63 of chapter C of subtitle F of the Interna Revenue Code of 1954 (the Code), as amended, are applicable. Sec. 402(a), Tax Equity and Fiscal Responsibility Act o 1982, Pub. L. 97-248, 96 Stat. 648. Therefore, treatment o the adjustments to petitioners' Federal income tax fo petitioners' taxable year 1982 arising from their interes and participation in the partnership is governed by th partnership audit and litigation provisions of the Code (se 6221 et seq.), and by our opinion in *Maxwell v. Commissioner, supra.*[3]

Accordingly,

An appropriate order will be issued

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[3] See also *Farris v. Commissioner*, T.C. Memo. 1986-467.

LEWIS HANFORD KESSLER, JR., AND KAY BETHARD KESSLER, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 29539-81. Filed December 8, 1986.

Petitioner-husband believes in "a/the Sun God" and that he must journey to the tropics for the purpose of religious worship and prayer. In accordance with this belief, petitioners took a trip to Puerto Rico. Petitioners claim charitable contribution deductions for expenses incurred in traveling to and from Puerto Rico and expenses incurred while staying there. *Held*:

1. Petitioners' expenses for their trip to Puerto Rico are not deductible under sec. 170, I.R.C. 1954.

2. Sec. 170, I.R.C. 1954, does not unconstitutionally prefer one religion over another by allowing deductions only for contributions to organized entities.

3. Petitioners lack standing to litigate the proposition that sec. 170, I.R.C. 1954, is unconstitutional because it has a primary effect which either advances or inhibits religion.

Lewis Hanford Kessler, Jr., pro se.
Pamela R. Martin, *for the respondent*.

CHABOT, *Judge*: Respondent determined a deficiency in ederal individual income tax against petitioners for 1978 in he amount of $1,380.65. After concessions by the parties, he issue for decision is whether petitioners may deduct, nder section 170,[1] their expenses in travelling to and rom, and staying in, Puerto Rico for the purpose of llowing petitioner-husband to engage in religious worship nd prayer.

FINDINGS OF FACT

Some of the facts have been stipulated; the stipulations nd the stipulated exhibits are incorporated herein by this eference.

When the petition was filed in the instant case, petitioners Lewis Hanford Kessler, Jr. (hereinafter sometimes eferred to as Lewis), and Kay Bethard Kessler (hereinafter sometimes referred to as Kay), husband and wife, resided in Ypsilanti, Michigan.

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[1] Unless indicated otherwise all section references are to sections of the Internal Revenue ode of 1954 as in effect for the year in issue.

Lewis' religious belief is in "a/the Sun God".[2] In accordance with his religious beliefs, Lewis makes annual journeys to the region located between the Tropic of Cancer and the Tropic of Capricorn (hereinafter sometimes referred to as the tropics) for the purpose of religious worship and prayer.

In 1978, Lewis made two trips south with Kay. One of the trips, however, was not to the tropics; the cost of this trip was not deducted by petitioners. The other trip was to Puerto Rico, which is in the tropics. On their trip to Puerto Rico, petitioners spent a total of $1,468.94. Of this total, $337.50 was for Kay's air fare.

All of the claimed deductions were expenses for petitioners' trip to Puerto Rico (i.e., transportation, hotel accommodations, meals, etc.) and none was spent for charity.

Lewis does not belong to an organization or congregation of Sun God worshippers. The expenses for the trip to Puerto Rico were not given or contributed to or for the use of a religious organization.

OPINION

Petitioners contend that respondent's interpretation of section 170 violates Lewis' rights under several provisions of the United States Constitution by allowing members of organized religions to deduct essentially all of their expenses of exercising their religions while denying petitioners the right to deduct their expenses of practicing their religion of worshipping the Sun God. In particular, petitioners contend that Lewis' rights under the following provisions of the Constitution are being violated: (1) article I, section 8, clause 1;[3] (2) article IV, section 2;[4] (3) article VI, clause 3;[5] (4) the First Amendment;[6] and (5) the 14th Amendment, section 1.[7]

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[2] No evidence was presented as to Kay's religious beliefs. Lewis testified that he does not know whether Kay shares his belief in the Sun God. Note that evidence about either petitioner's religious beliefs is presented to support petitioners' contentions as to their constitutional rights, and not for a purpose which is prohibited by Rule 610 of the Federal Rules of Evidence.

[3] We assume that petitioners refer to the requirement that "all Duties, Imposts and Excises shall be uniform throughout the United States".

[4] We assume that petitioners refer to the "privileges and immunities" clause.

Respondent asserts that section 170 is applied to all taxpayers in an equal fashion and contends that the provision does not violate the Constitution.

We agree with respondent.

Under section 170,[8] a taxpayer may deduct a contribution or gift to or for the use of "A corporation, trust, or community chest, fund, or foundation— * * * organized and operated exclusively for" certain specified purposes. Sec.

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[5] We assume that petitioners refer to the requirement that "no religious Test shall ever be required as a Qualification to any office or public Trust under the United States."

[6] The First Amendment to the United States Constitution reads as follows:

"Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances."

[7] We assume that petitioners refer to the "equal protection" clause, which directly applies only to the States, but which is treated as being subsumed in the due process clause of the Fifth Amendment, which in turn is a restriction on the powers of the Federal Government. *Johnson v. Robison*, 415 U.S. 361, 364 n. 4 (1974); *Bolling v. Sharpe*, 347 U.S. 497 (1954).

[8] Sec. 170 provides, in relevant part, as follows:

SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) ALLOWANCE OF DEDUCTION.—

(1) GENERAL RULE.—There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

* * * * * * *

(c) CHARITABLE CONTRIBUTION DEFINED.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—

* * * * * *

(2) A corporation, trust, or community chest, fund, or foundation—

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B).

The subsequent amendment of this provision by sec. 286(b) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324, 570, does not apply to the instant case.

170(c)(2)(B). In addition, the donee entity must be "created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States". Sec. 170(c)(2)(A). In all cases, in order for the contribution to be deductible under section 170, the contribution or gift must be to or for the use of an organized entity.

Petitioners concede that they "do not qualify under the IRS interpretation of Sect 170". More to the point, since their expenses were not contributions or gifts to an organized entity, these expenses clearly do not qualify under the statute as written. *Stark v. Commissioner*, 86 T.C. 243, 256 (1986); *Bilingual Montessori School of Paris v. Commissioner*, 75 T.C. 480 (1980); *Dohrmann v. Commissioner*, 18 B.T.A. 66, 68 (1929). See *Weingarden v. Commissioner*, 86 T.C. 669 (1986), on appeal (6th Cir., July 16, 1986).

Section 170 clearly allows a deduction for gifts or contributions to organized churches. Sec. 170(b)(1)(A)(i); compare *Canelo v. Commissioner*, 41 B.T.A. 713, 720, 734 (1940), with *Chapman v. Commissioner*, 48 T.C. 358 (1967). Members of an organized church may, as a practical matter, share the costs of support of the organization (e.g., *Larson v. Valente*, 456 U.S. 228, 246-247 n. 23 (1982)) and deduct their payments toward these costs. E.g., *Ortseifen v. Commissioner*, 14 B.T.A. 1403 (1929).[9] In contrast, Lewis holds religious beliefs that do not involve an organization to further his ability to exercise his religion. Nonetheless, he incurs expenses in exercising his religious beliefs. Because section 170 as written does not allow him a tax deduction for expenses he incurs in the exercise of his religion, petitioners contend that they are denied equal treatment solely because of the form in which Lewis chooses to exercise his religious beliefs. The issue to be decided is whether the distinction effectively drawn by the statute between worshippers in organized religions and those who choose to worship without an organized religion results in a governmental preference to organized religions in violation of the First Amendment.

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[9] However, a deduction is not available where the payment is made with the expectation of receiving in return a particularized commensurate benefit to the payor. *DeJong v. Commissioner*, 309 F.2d 373 (9th Cir. 1962), affg. 36 T.C. 896 (1961); *Graham v. Commissioner*, 83 T.C. 575, 580-581 (1984), on appeal (9th Cir., Nov. 19, 1984).

The Congress may make classifications among taxpayers as it deems necessary and proper (see U.S. Const. art. I, sec. 8[10]) unless limited by other provisions of the Constitution.

In *Nicol v. Ames*, 173 U.S. 509 (1899), the Supreme Court set forth as follows (pp. 514-515) the overall approach we must take to challenges to the constitutionality of a Federal tax law:

> It is always an exceedingly grave and delicate duty to decide upon the constitutionality of an act of the Congress of the United States. The presumption, as has frequently been said, is in favor of the validity of the act, and it is only when the question is free from any reasonable doubt that the court should hold an act of the lawmaking power of the nation to be in violation of that fundamental instrument upon which all the powers of the Government rest. This is particularly true of a revenue act of Congress. The provisions of such an act should not be lightly or unadvisedly set aside, although if they be plainly antagonistic to the Constitution it is the duty of the court to so declare. The power to tax is the one great power upon which the whole national fabric is based. It is as necessary to the existence and prosperity of a nation as is the air he breathes to the natural man. It is not only the power to destroy, but it is also the power to keep alive.

In particular, if a tax law's classification scheme is challenged, then "Normally, a legislative classification will not be set aside if any state of facts rationally justifying it is demonstrated to or perceived by the courts." *United States v. Maryland Savings-Share Ins. Corp.*, 400 U.S. 4, 6 (1970), revg. per curiam 308 F. Supp. 761 (D. Md. 1970). Respondent need not demonstrate that the Congress actually considered such a state of facts, if the facts are perceptible to this Court. *Bryant v. Commissioner*, 72 T.C. 757, 764 (1979).

However, where the classification scheme involves an area that is constitutionally protected, more is required than a

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[10] Art. I, sec. 8 provides, in pertinent part, as follows:

Section 8. The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; * * *—And

To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

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rational relationship in order to sustain it. See *Bryant v. Commissioner*, 72 T.C. at 763, and cases there cited. Religious liberty is a basic right guaranteed by the Constitution and classification according to religious belief needs more than a rational relationship to sustain it. *Sherbert v. Verner*, 374 U.S. 398, 406-407 (1963); *Fowler v. Rhode Island*, 345 U.S. 67, 69 (1953). See *United States v. Seeger*, 380 U.S. 163, 176 (1965); *Golden Rule Church Association v. Commissioner*, 41 T.C. 719, 729-730 (1964).

In *Larson v. Valente*, *supra*, the Supreme Court stated that when a court is presented with a law "granting a denominational preference, our precedents demand that we treat the law as suspect and that we apply strict scrutiny in adjudging its constitutionality." 456 U.S. at 246. The Court went on to explain that if a law grants a denominational preference, then "that rule must be invalidated unless it is justified by a compelling governmental interest, cf. *Widmar v. Vincent*, 454 U.S. 263, 269-270 (1981), and unless it is closely fitted to further that interest, *Murdock v. Pennsylvania*, 319 U.S. 105, 116-117 (1943)." 456 U.S. at 247.

Where we deal with a classification allegedly granting a denominational preference, the fact that the alleged discrimination arises from the Congress' exercise of its taxing power does little to insulate the statute from scrutiny. In *Flast v. Cohen*, 392 U.S. 83, 103-104 (1968), the Supreme Court recognized as follows:

> one of the specific evils feared by those who drafted the Establishment Clause and fought for its adoption was that the taxing and spending power would be used to favor one religion over another or to support religion in general. * * * The concern of Madison and his supporters was quite clearly that religious liberty ultimately would be the victim if government could employ its taxing and spending powers to aid one religion over another or to aid religion in general. * * *

In *Larson v. Valente*, *supra*, a State statute which exempted some religious organizations from the State's charitable organization reporting laws was held to be an unconstitutional grant of denominational preference. The statute provided "that only those religious organizations that received more than half of their total contributions from members or affiliated organizations would remain exempt from the registration and reporting requirements of the Act." 456 U.S. at 231-232. In distinguishing the statute in *Larson v. Valente* from statutes which the Court had held not to grant an unconstitutional religious preference, the Court stated (456 U.S. at 246-247 n. 23) as follows:

> As we noted in *Gillette* [*v. United States*], the "critical weakness of petitioners' establishment claim" arose "from the fact that § 6(j), on its face, simply [did] not discriminate on the basis of religious affiliation." 401 U.S., at 450. In contrast, the statute challenged in the case before us focuses *precisely and solely upon religious organizations*. [Emphasis supplied.]

Section 170, unlike the statute in *Larson v. Valente*, grants a deduction for gifts or contributions to a broad class of organizations. In upholding as constitutional a New York statute granting property tax exemptions to religious organizations, the Supreme Court stated in *Walz v. Tax Commission*, 397 U.S. 664, 673 (1970), as follows:

> [The State] has not singled out one particular church or religious group or even churches as such; rather, it has granted exemption to all houses of religious worship within a broad class of property owned by nonprofit, quasi-public corporations which include hospitals, libraries, playgrounds, scientific, professional, historical, and patriotic groups. The State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification useful, desirable, and in the public interest. * * *

The requirement in section 170 that all donees be organizations applies equally to the religious and the nonreligious. Consequently, unlike the statute in *Larson v. Valente*, section 170 does not focus "precisely and solely on religious organizations".

In proposing on the Senate Floor the first charitable contribution deduction provision in 1917, Senator Hollis of New Hampshire explained the purpose of his provision as follows (55 Cong. Rec. 6728):

> Usually people contribute to charitable and educational objects out of their surplus. After they have done everything else they want to do, after they have educated their children and traveled and spent their money on everything they really want or think they want, then, if they have something left over, they will contribute it to a college or to the Red Cross or for some scientific purposes. Now, when war comes and we impose these very heavy taxes on incomes, that will be the first place where the wealthy men will be tempted to economize, namely, in donations to charity. They will say, "Charity begins at home."

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Section 170, like the property tax exemption in *Walz v. Tax Commission*, is designed to benefit a broad class of institutions. The legislature granted a deduction for charitable contributions to ensure that the income tax would not impede the flow of funds to institutions that form an integral part of the fabric of cur society. That this is a valid secular purpose has been recognized by the Supreme Court. *Walz v. Tax Commission*, 397 U.S. at 673.

The section 170 requirement that a donation be to an organized entity is secular and necessary to carry out the valid purposes of section 170. The purposes of the charitable contribution deduction can only be furthered if the Government can be assured that the funds are appropriately expended. Without an organization that can be audited and examined, the ability of the Government to acquire this assurance is greatly diminished.

We do not question the sincerity of Lewis' beliefs[11] nor are we presented with a governmental statute that would prevent the exercise of those beliefs. The financial burden on petitioners here is not so grievous as to render the denial of the deduction an unconstitutional burden on petitioners' free exercise rights. *United States v. Lee*, 455 U.S. 252 (1982); cf. *Sherbert v. Verner, supra*. Petitioners are free to practice their religion, they just will not be subsidized. *Cammarano v. United States*, 358 U.S. 498 (1959).

In *Graham v. Commissioner*, 83 T.C. 575, 583 (1984), on appeal (9th Cir., Nov. 19, 1984), we stated as follows:

> The instant case is distinguishable from *Larson* because section 170, unlike the charitable solicitation law in *Larson*, does not make classifications among religions. Furthermore, unlike *Larson*, here there is no legislative history revealing overt discrimination. Finally, even if section 170 has the effect of advancing one religion more than another, that fact alone does not make the statute unconstitutional. The establishment clause does not prohibit a statute from having a disparate impact on religious organizations provided the disparate impact results from the application of secular criteria. *Lynch v. Donnelly*, 465 U.S. [668] (1984); *Gillette v. United States*, 401 U.S. 437, 452 (1971); *McGowan v. Maryland*, 366 U.S. 420, 442-444 (1961). Here the tests for determining the deductibility of claimed charitable contributions are based on secular criteria. Further, *Larson* is distinguishable from the case at bar because the section 170 classification bears equally upon all religious organiza-

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[11] Of course, we could not constitutionally question the validity of Lewis' beliefs. *United States v. Seeger*, 380 U.S. 163, 184-185 (1965).

tions. Thus, there is not the political divisiveness here that was prevalent in *Larson*. Accordingly, the argument of unconstitutionality under the establishment clause is rejected.

We hold that section 170 does not prefer one religion over another in violation of Lewis' rights under the First Amendment.

We have dealt with petitioners' attack on section 170 in light of their contention that the claimed unconstitutionality of that section could be cured by an expansion of the statute to allow a deduction for their trip to Puerto Rico. We have concluded that the statute does not unconstitutionally discriminate between Lewis' religion and organized churches.

Petitioners apparently also contend that section 170 is unconstitutional because it has a primary effect which either advances or inhibits religion. *Committee for Public Education v. Nyquist*, 413 U.S. 756, 773 (1973); *Lemon v. Kurtzman*, 403 U.S. 602, 612 (1971). If we were to find section 170 unconstitutional as having a primary effect of either advancing or inhibiting religion, we could not allow the statute to stand. Without section 170 we would have no statute under which to allow petitioners' claimed deduction. As a result, petitioner would receive no relief from our resolution of this issue. Since we are unable to grant relief to petitioners through the resolution of this issue, petitioners lack the requisite standing needed to raise this issue. As a result, we do not resolve this issue in the instant case. *Lane-Burslem v. Commissioner*, 72 T.C. 849 (1979), affd. 659 F.2d 209 (D.C. Cir. 1981); *Lingenfelder v. Commissioner*, 38 T.C. 44, 45 (1962). See *Golden Rule Church Association v. Commissioner*, 41 T.C. at 731. But see *Davis v. Maryland*, 294 Md. 370, 451 A.2d 107 (1982).

Petitioners also state that Lewis' rights under a number of other provisions of the United States Constitution (see notes 3-7, *supra*) are violated by "IRS interpretation of Section 170". They then state that "For me to embellish or attempt to more clearly define the Constitution is clearly not required." Petitioners are mistaken. We will not guess at claims of unconstitutionality. It is a serious business to consider whether the Nation's legislature has violated the Constitution under which it is established and under which it acts. See *Nicol v. Ames*, *supra*. We will not decide such questions unless they are properly presented and must be decided in order to determine whether petitioners have a deficiency and, if so, in what amount. Compare, e.g., *Bryant v. Commissioner*, 72 T.C. at 759, with *Golden Rule Church Association v. Commissioner*, 41 T.C. at 730-731.

We hold for respondent on the one matter presented to us; because of respondent's concessions on other matters,

Decision will be entered under Rule 155.

JAMES E. THRELKELD, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 9270-83. Filed December 8, 1986.

Petitioner settled a civil lawsuit for malicious prosecution and other claims for $300,000, of which the parties to the lawsuit allocated $75,000 to injury to petitioner's professional reputation. *Held*, there is no valid distinction between damages received for injury to personal reputation and those received for injury to professional or business reputation for purposes of sec. 104(a)(2), I.R.C. 1954. *Roemer v. Commissioner*, 79 T.C. 398 (1982), revd. 716 F.2d 693 (9th Cir. 1983), will be no longer followed. *Held, further*, damages received in settlement of a claim for malicious prosecution of a civil proceeding under Tennessee law are damages received on account of "personal injuries." Sec. 104(a)(2), I.R.C. 1954.

G. Keith Rogers, Jr., for the petitioner.
Robert P. Crowther, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income taxes for the taxable years 1979 and 1980 in the amounts of $3,225.37 and $18,838.18, respectively. After concessions by the parties, the sole issue for decision is whether the amount of $21,500 received in 1980 in settlement of a suit for malicious prosecution that represented recovery for injury to petitioner's professional reputation is excludable from income under section 104(a)(2).[1]

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and accompanying exhibits are incorporated by this reference.

Petitioner filed a Federal income tax return for the taxable year 1980 with the Internal Revenue Service Center, Memphis, Tennessee. Petitioner was a resident of Memphis, Tennessee, at the time he filed his petition in this case.

In May 1975, J.B. Williams (Williams), a Texas resident, filed a lawsuit against petitioner and a codefendant in the Chancery Court of Shelby County, Tennessee, alleging fraud in connection with a real estate sales contract. Petitioner counterclaimed against Williams seeking specific performance of the contract. The court subsequently found for petitioner and his codefendant both upon Williams' claim for rescission and upon defendants' counterclaim for specific performance and awarded the defendants a judgment in the amount of $1,283,527.07. The judgment of the chancery court was upheld on appeal, and the Supreme Court of Tennessee denied an application for a writ of certiorari filed by Williams.

On May 10, 1979, petitioner filed suit in the U.S. District Court for the western district of Tennessee against Williams with jurisdiction being based upon diversity of citizenship. Petitioner alleged that Williams "instituted, continued, and prosecuted his claims" in the suit before the Chancery Court of Shelby County, Tennessee, "without probable cause and with malice." Petitioner also alleged that Williams' actions in bringing the suit for rescission in the chancery court caused petitioner various injuries described as follows:

> Plaintiff was subjected to indignity, humiliation, inconvenience, and pain and distress of mind, was prevented from attending to his usual professional pursuits, incurred expenses and costs in defending Defen-

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in question, and all Rule references are to the Tax Court Rules of Practice and Procedure.

dant's claims in and pertaining to the chancery suit, suffered injury to his professional reputation, and suffered injury to his credit reputation.

Petitioner's complaint included a prayer for compensatory damages in the amount of $250,000 and punitive damages in the amount of $1 million.

After instituting the suit for malicious prosecution against Williams in Federal court, petitioner filed two other lawsuits against Williams, his wife, Jean Proctor Williams, and others. These suits alleged that certain fraudulent conveyances of property were made in an attempt to insulate those properties from petitioner's judgment obtained in the original chancery court suit.

On December 8, 1980, petitioner and the Williamses entered into an agreement settling the suit for malicious prosecution. As part of the same agreement, petitioner agreed to release all other pending claims. Petitioner also agreed to assign the original chancery court judgment. As total consideration in settlement of his various claims, petitioner was to receive $300,000 allocated as follows:

> (b) For the release by Threlkeld of his claims against J.B. Williams asserted in [the malicious prosecution action] for damage to Threlkeld's professional reputation, * * * $75,000.00.
>
> (c) For the release by Threlkeld of his claims against J.B. Williams asserted in [the malicious prosecution action] for damage to Threlkeld's credit reputation, * * * $75,000.00.
>
> (d) For the release by Threlkeld of his claims against J.B. Williams asserted in [the malicious prosecution action] for indignity, humiliation, inconvenience, and pain and distress of mind, * * * $74,980.00.
>
> * * * * * * *
>
> (f) For the assignment of the Judgment by Threlkeld * * * $75,000.00.

The settlement agreement also allocated $10 each as consideration for the release by petitioner of two suits alleging fraudulent conveyances by Williams that were intended to defeat the execution of the judgment for specific performance. No amount was characterized as payment for punitive damages.

In 1980, petitioner received $86,000 of the total settlement of $300,000, of which $21,500 represented a portion of the amount allocated to the damage to professional reputation. He received the remainder of the $300,000 settlement in 1981.

On his individual Federal income tax return for the taxable year 1980, petitioner reported $1,500 as long-term taxable gain from the portion of the settlement relating to the decree of specific performance. He did not report as taxable income for the taxable year 1980 any other portion of the $86,000 he received.

In his statutory notice of deficiency for the taxable years 1979 and 1980, the Commissioner determined deficiencies in petitioner's income tax of $3,225.37 and $18,838.18, respectively. The deficiency for the taxable year 1980 resulted, in part, by increasing petitioner's taxable income in the amount of $55,902 representing unreported income received as part of the settlement agreement. After concessions by the parties, the sole remaining issue is the excludability of the $21,500 received by petitioner in 1980 as payment for injury to his "professional reputation."

OPINION

We are called upon to decide whether an amount received that was specified as a recovery for injury to petitioner's professional reputation arising out of a claim of malicious prosecution is excludable from taxable income under section 104(a)(2).

Section 61 provides that, except as otherwise provided, gross income means "all income from whatever source derived." Section 104(a)(2) provides that "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness" is excludable from gross income. The regulations promulgated under section 104(a)(2) provide that "damages received" means an amount received from an action based upon tort or tort-type rights. Sec. 1.104-1(c), Income Tax Regs. The law is well settled that the tax consequences of an award for damages depend upon the nature of the litigation and on the origin and character of the claims adjudicated, and not upon the validity of those claims. *Bent v. Commissioner*, 87 T.C. 236 (1986) ; *Glynn v. Commissioner*, 76 T.C. 116, 119 (1981), affd. without published opinion 676 F.2d 682 (1st Cir. 1982); *Seay v. Commissioner*, 58 T.C. 32, 37 (1972). No distinction is made between physical and nonphysical (mental or emotional) injuries. *Seay v. Commissioner, supra* at 40. However, in the case of damages awarded in defamation suits, this Court has drawn a distinction between damages received for an injury to personal reputation and those received for injury to professional reputation. One of our recent opinions setting forth this distinction was reversed by the Court of Appeals for the Ninth Circuit. *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983), revg. 79 T.C. 398 (1982). Based upon our careful consideration of the opinion of the Court of Appeals in *Roemer v. Commissioner*, *supra*, and after close scrutiny of all of our decisions in this area, we conclude that, for purposes of section 104(a)(2), there is no justification for continuing to draw a distinction, in tort actions, between damages received for injury to personal reputation and damages received for injury to professional reputation.

The factual setting of *Roemer v. Commissioner*, 79 T.C. 398 (1982), is fairly straightforward. The Court was confronted with the proper tax treatment of the proceeds of a jury award for compensatory and punitive damages arising from a libel suit filed in a California State court.[2] The libel suit was based upon the publication of a defamatory credit report that resulted in the loss of business opportunities. The allegations contained in his State court complaint and the evidence produced at trial both emphasized the injurious effect of the defamatory report on the taxpayer's business reputation and demonstrated that the report resulted in lost income and business opportunities. The taxpayer sought to exclude the damage award under section 104(a)(2) as an amount received on account for personal injuries.

In our opinion in *Roemer v. Commissioner*, *supra*, we addressed, as a threshold question, the necessity for drawing a distinction, for purposes of the exclusion of damages received on account of personal injuries under section 104(a)(2), between personal reputation and business or professional reputation. After deciding that just such a distinction was required, we concluded that the full amount of the compensatory damages received by the taxpayer was includable in his gross income. 79 T.C. at 407.

The Court of Appeals for the Ninth Circuit in the appeal of *Roemer* held that no distinction between injuries to personal and professional reputation was justified under section 104(a)(2). 716 F.2d at 697. Because the damages at issue were awarded pursuant to a defamation action, the court analyzed the nature of defamation under State law to decide whether the injuries which the taxpayer suffered were "personal."

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[2] The taxability of punitive damages is not an issue before us in the instant case.

After an exhaustive review of the history of defamation under California law, the court concluded that a defamation action involved distinctly personal injuries. The court characterized defamation as follows:

> Although there are different types of defamation actions (libel or slander) depending on the form of the defamatory statements, all defamatory statements attack an individual's good name. This injury to the person should not be confused with the derivative consequences of the defamatory attack, i.e., the loss of reputation in the community and any resulting loss of income. The nonpersonal consequences of a personal injury, such as a loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of an injury should not be defined by its effect. [716 F.2d at 699; fn. ref. omitted.]

The Court of Appeals viewed the problem of recoveries for defamation from the proper perspective. Section 104(a)(2) excludes from income amounts received as damages on account of personal injuries. Therefore, whether the damages received are paid on account of "personal injuries" should be the beginning and the end of the inquiry. To determine whether the injury complained of is personal, we must look to the origin and character of the claim (*Glynn v. Commissioner, supra; Seay v. Commissioner*, 58 T.C. at 38), and not to the consequences that result from the injury. No doubt a defamatory statement that injures a person's professional reputation will result in lost income. In such cases, the amount of income lost is an accurate measure of the damage sustained because of the injury to reputation. However, the extent to which income is decreased, even though this may be the best measure of loss, in no way changes the nature of the claim. "It is simply not enough that the injury arose in connection with the taxpayer's business or his professional endeavor, or that the injury is somehow remotely capable of affecting his income." *Church v. Commissioner*, 80 T.C. 1104, 1109 (1983) (distinguishing *Roemer v. Commissioner*, 79 T.C. 398 (1982)).

The validity of the distinction between damages received for injuries to personal reputation and those received for injuries to professional reputation is further undermined by considering the disparate treatment given to damage awards received for physical injuries. The exclusion for damages received for personal injuries has long been extended to nonphysical, as well as physical, injuries by this Court and respondent. *Hawkins v. Commissioner*, 6 B.T.A. 1023 (1927); Sol. Op. 132, I-1 C.B. 92 (1922). If a taxpayer receives a damage award for a physical injury, which almost by definition is personal, the entire award is excluded from income even if all or a part of the recovery is determined with reference to the income lost because of the injury. Where, however, the damage award is received for a nonphysical injury, we have previously mounted an inquiry to determine whether the components of the injuries for which the award is made are personal or professional.

This inconsistency is graphically illustrated by considering the case of a young surgeon who loses a finger because of the tortious conduct of another. See *Roemer v. Commissioner*, 79 T.C. at 414 (Wilbur, *J.*, dissenting). This injury will surely cause the surgeon compensable general damages, such as physical and emotional pain and suffering, but it will also undoubtedly cause special damages including loss of future income. In order to prove the extent of the damages flowing from a clearly personal injury, the surgeon will likely produce evidence of both his actual pain and suffering and his loss of income. However, because it is easier to place a present dollar value upon the loss of future income than upon an intangible such as emotional pain, the surgeon will quite predictably place greater emphasis on lost income as a measure of his damages and will perhaps, thereby, receive a greater recovery. In such a case, the entire damage award or settlement amount received will be excluded from income. The fact that the tortious conduct causing the severed digit manifested itself in the loss of future income to the surgeon raises no troubling questions as to the exclusion of the award. Where, however, a taxpayer's injuries are nonphysical we have, in the past, ignored the personal nature of the claim and delved into an inquiry regarding the nature of the consequences of the injury. See *Roemer v. Commissioner*, 716 F.2d at 700.

Not only does the distinction between damages for injury to personal reputation and those for professional reputation create an inconsistency between physical and nonphysical personal injuries that is analytically irreconcilable, the distinction also lacks a firm foundation in the case law of this Court.

The origin of the personal/professional reputation dichotomy has been attributed to a 1922 opinion of the Solicitor of Internal Revenue. Sol. Op. 132, I-1 C.B. 92 (1922). In that opinion, it was held that amounts received, whether by agreement of the parties or judgment of a court, on account of damages for defamation of personal character do not constitute income. I-1 C.B. at 93. However, the opinion did not extend to the taxability of damages received for defamation of business reputation or property rights. I-1 C.B. at 94. Nevertheless, in a 1958 ruling, the Commissioner cited the 1922 Solicitor's Opinion as authority for distinguishing between damages received for injury to personal reputation and those received for injury to professional reputation. Rev. Rul. 58-418, 1958-2 C.B. 18, 19.

This Court first considered the exclusion from gross income for damages received for personal injuries in *Hawkins v. Commissioner*, *supra*. In *Hawkins*, the taxpayer was removed from the office of president of a corporation by its directors. The taxpayer contemplated bringing suit against the corporation and some of its officers because of certain defamatory statements made by the officers. He alleged injury to his "reputation, business and health." Before a lawsuit was filed, however, the taxpayer settled his claims with the corporation. In deciding that the settlement award was not taxable, the Court held that the entire amount represented general damages for the personal injury caused by the defamatory statements. 6 B.T.A. at 1024. Although the defamation arose in the context of his employment, the Court stated that the settlement award "was compensation for injury to his personal reputation for integrity and fair dealing, including, as the record indicates, the injury to his health. * * * Here there is only the compensation which the law sanctions as the only remedy which has thus far been devised for an injury which in its nature is wholly personal and nonpecuniary." 6 B.T.A. at 1024-1025. Quite notably, however, the Court in no way suggested that it must decide whether the settlement award represented compensation for an injury to the taxpayer's personal reputation or to his professional reputation.

We again confronted the taxability of payments received by a taxpayer in the context of his termination of employment in a Memorandum Opinion of this Court, *Agar v. Commissioner*, T.C. Memo. 1960-21, affd. 290 F.2d 283 (2d Cir. 1961). In *Agar v. Commissioner, supra*, the taxpayer submitted his resignation and then informed his former employers he intended to file a suit for damages based upon alleged mistreatment. Before any suit was filed, however, the corporation agreed to pay the taxpayer $45,000. The taxpayer argued before this Court that the amounts received from his former employer represented settlement of a proposed suit for injury to personal reputation and health. As such, he argued that those payments should be excludable from taxable income as compensation for a personal injury under our decision in *Hawkins v. Commissioner, supra*. The Court, however, found the payments not to be excludable on two grounds. First, the payments were not made in settlement of a claim of defamation, but rather constituted additional compensation to the taxpayer for his many years of service to the corporation. Second, the payments were more properly characterized as compensation for injuries done to the taxpayer's *business* reputation rather than his *personal* reputation.[3] The Court of Appeals for the Second Circuit affirmed our decision based upon the first rationale and the payments received were, therefore, taxable. 290 F.2d at 284. More importantly for our purposes today, the Court of Appeals declined to rule upon our distinction between personal and professional reputation:

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[3] As authority for treating amounts received as compensation for injury to personal reputation differently than amounts received for injury to professional reputation, we relied upon our decision in *Draper v. Commissioner*, 26 T.C. 201 (1956). In *Draper* and an earlier decision of this Court cited in *Draper*, *Kleinschmidt v. Commissioner*, 12 T.C. 921 (1949), we were confronted with the question of the deductibility of attorney's fees incurred by the taxpayer in a defamation suit. The question in these cases was whether the legal fees represented deductible trade or business expenses or nondeductible personal expenses. See secs. 162(a), 262; see also sec. 212. Regardless of the correctness of our decision in *Draper*, see *Wolfson v. Commissioner*, T.C. Memo. 1978-445, n. 10 (questioning whether *Draper* and *Kleinschmidt* are reconcilable), the inquiry required in that case is different than that required of us by sec. 104(a)(2) and provides little guidance regarding the meaning of "personal injury."

> Since we affirm upon the first ground, we do not have to decide whether whatever tort claim Agar may have asserted was based upon damage to his personal as well as his business reputation, assuming that the dichotomy is realistic, and whether all payments or a portion of them would therefore be tax exempt. * * * [290 F.2d at 284.]

In later opinions, we held that a distinction must be drawn between recoveries for injuries to personal reputation and to professional reputation. *Glynn v. Commissioner*, 76 T.C. at 120; *Wolfson v. Commissioner*, T.C. Memo. 1978-445, affd. and remanded 651 F.2d 1228 (6th Cir. 1981); *Knuckles v. Commissioner*, T.C. Memo. 1964-33, affd. 349 F.2d 610 (10th Cir. 1965). However, in none of these opinions have we relied upon this distinction to decide the case. In *Glynn v. Commissioner, supra*, the Court denied an exclusion for amounts received by the taxpayer pursuant to an agreement upon the termination of his employment. Although the Court, in dictum, referred to the personal/professional reputation distinction, the basis for the denial of the deduction was that the gravamen of the settled claim was for recovery of accrued sick leave that would clearly be taxable income under section 61. 76 T.C. at 120-122.

Similarly, in *Knuckles v. Commissioner, supra*, another Memorandum Opinion of this Court, we held that payments received under an agreement with a former employer represented settlement of the taxpayer's claims under an employment contract. Although there was evidence of damage to the taxpayer's business reputation, the Court was unmoved by the taxpayer's tardy and self-serving claim that the amounts received were in settlement of a claim for personal injuries and, therefore, excludable.[4]

Later, in another Memorandum Opinion, *Wolfson v. Commissioner*, T.C. Memo. 1978-445, affd. and remanded 651 F.2d 1228 (6th Cir. 1981), we upheld the Commissioner's determination that the taxpayer must include in taxable income amounts received in settlement of a lawsuit against a medical school with which the taxpayer was associated as a teacher and researcher. Although we found that the amounts received represented compensation for injury to the taxpayer's professional reputation, we expressly refused to decide "whether there is a valid distinction between damage to one's personal reputation and damage to an employee's professional reputation for purposes of section 104(a)(2)." Our decision in *Wolfson v. Commissioner*, T.C. Memo. 1978-445, was affirmed by the Court of Appeals for the Sixth Circuit, which is the court to which the instant case is appealable. 651 F.2d 1228 (1981). In affirming *Wolfson*, the Court of Appeals found our determination to be not clearly erroneous while indicating inferentially that the result this Court reached was supportable because the payments received by the taxpayer represented the recovery of taxable earnings. The court did not endeavor to determine the validity of our distinction for damages received for injury to reputation in defamation suits.

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[4] On appeal of the case, the Court of Appeals for the 10th Circuit affirmed this Court because the finding that the taxpayer's claim was not for personal injury was not clearly erroneous. *Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965). The Court of Appeals did not address the propriety of the personal/professional reputation dichotomy.

As the foregoing demonstrates, with the exception of our decision in *Roemer v. Commissioner*, 79 T.C. 398 (1982), this Court has never relied, as the sole basis for deciding the case, upon the distinction drawn between damages received for injury to personal reputation and those for injury to professional reputation, divined from the 1922 Solicitor's Opinion. To be sure, some of our cases have indicated approval of this distinction. Nevertheless, no Court of Appeals has approved the distinction; one Court of Appeals, the Ninth Circuit, has determined the distinction to be invalid (*Roemer v. Commissioner*, 716 F.2d 693 (9th Cir. 1983)), and another, the Second Circuit, has questioned its validity (*Agar v. Commissioner*, 290 F.2d 283 (2d Cir. 1961)).

We do not lightly decline to follow one of our prior decisions; no court bound by the doctrine of stare decisis does. But where one of our decisions lacks a firm foundation in the case law and an appellate court issues a well-reasoned reversal of that decision, the weight of precedent must give way to a better approach. Therefore, we will no longer distinguish between personal reputation and professional reputation for the purpose of deciding whether a damage award received in a tort action is excludable from gross income under section 104(a)(2).

Because we have concluded that the appropriate question for purposes of section 104(a)(2) is whether the damages were received on account of personal injuries, we must next decide what "personal injuries" are. The question is one of fact. *Seay v. Commissioner*, 58 T.C. at 37. The determination of whether damages are received on account of a personal injury properly depends on the nature of the claim. *Bent v. Commissioner, supra*; *Glynn v. Commissioner, supra*; *Seay v. Commissioner, supra*. Neither section 104(a)(2) nor its legislative history provides much guidance in this regard.[5] A personal injury has long been understood to include nonphysical as well as physical injuries. *Seay v. Commissioner, supra*; *Hawkins v. Commissioner*, 6 B.T.A. 1023 (1927); Sol. Op. 132, *supra*. Therefore, "personal" must be defined more broadly than "bodily" injury. The exclusion under section 104(a)(2) deals with damages received as a result of litigation or by an agreement in lieu of litigation. The regulations under section 104(a)(2) narrow the scope of damages received to those amounts received through prosecution of tort or tort-type rights. Therefore, "The essential element of an exclusion under section 104(a)(2) is that the income involved must derive from some sort of tort claim against the payor." *Glynn v. Commissioner*, 76 T.C. at 119. As a result, common law tort law concepts are helpful in deciding whether a taxpayer is being compensated for a "personal injury."

In *Roemer v. Commissioner*, 716 F.2d 693 (9th Cir.1983), the Court of Appeals relied solely upon the State law categorization of defamation as a personal injury to conclude that the compensatory portion of the judgment received by the taxpayer was excludable. Although we agree that the nature of the claim as defined under State law, and the concept of personal injury thereby embodied, are the appropriate criteria in the case of a court judgement or settlement agreement in which damages are clearly allocated to an identifiable claim, reliance on State law, alone, cannot determine the availability of the exclusion under section 104(a)(2) in all situations.[6]

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[5] Sec. 104(a)(2) remains substantially similar to its original predecessor, which was enacted as part of the Revenue Act of 1918, ch. 18, sec. 213(b)(6), 40 Stat. 1057, 1065-66 (1919). The legislative history of the Revenue Act of 1918 fails to define "personal injuries or sickness." H. Rept. 767, 65th Cong. 2d Sess. (1918), 1939-1 C.B. (Part 2) 86, 92. The legislative history of the Internal Revenue Code of 1954 also fails to define "personal injuries or sickness." H. Rept. 1337, 83d Cong. 2d Sess. 15 (1954); S. Rept. 1622, 83d Cong., 2d Sess. 15-16 (1954).

State law may be of limited assistance where, in a settlement, the claim settled is itself unclear. Similarly, State law is of little help where there are several claims, only some of which are for personal injuries. The State law classification of the various claims will be of no assistance identifying the claim or claims or in carving up the damage recovery. In such cases, we must look to various factors, including the allegations in the State court pleadings, the evidence adduced at trial, a written settlement agreement, and the intent of the payer. *Church v. Commissioner*, 80 T.C. 1104 (1983); *Fono v. Commissioner*, 79 T.C. 680, 696 (1982), affd. without published opinion 749 F.2d 37 (9th Cir. 1984); *Glynn v. Commissioner*, 76 T.C. at 120; *Wolfson v. Commissioner*, T.C. Memo. 1978-445, affd. and remanded 651 F.2d 1228 (6th Cir. 1981). In a given case, any one of these factors may be ultimately persuasive or ignored. See *Wolfson v. Commissioner*, T.C. Memo. 1978-445 (where the State trial court judge's opinion provides some evidence, but is not dispositive of the nature of damages); *Knuckles v. Commissioner*, T.C. Memo. 1964-33 (complaint alleging tort was motivated by desire for favorable tax treatment of amount received in settlement of employment contract claim). Because of the multitude of situations involving the payment of damages for an allegedly personal injury, the most that can be said is that we will look to all of the facts and circumstances to determine whether the injury is, in fact, personal. See *Seay v. Commissioner*, 58 T.C. at 37.

In the instant case we have before us a written settlement agreement specifically allocating $75,000 to injuries to petitioner's professional reputation arising out of a claim of malicious prosecution. However, the specific allocation contained in the settlement agreement does not necessarily control in deciding whether the claim being settled arises from a personal injury. We, therefore, look to petitioner's allegations in his complaint in the State court. From the complaint, we find that petitioner alleged malicious prosecution arising out of the lawsuit filed by Williams to set aside a real estate contract on account of alleged fraud by petitioner.

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[6] It has often been stated that State law creates legal interests and rights, but Federal statutes determine when and how they shall be taxed. *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940); *Burnet v. Harmel*, 287 U.S. 103, 110 (1932). However, Congress may indicate, either expressly or by implication, that the operation of a taxing statute depends upon State law classifications. *Jerome v. United States*, 318 U.S. 101, 104 (1942); *Poe v. Seaborn*, 282 U.S. 101, 110 (1930).

We find that the use of the terms "damages" and "personal injury" by Congress necessarily implies that the exclusion under sec. 104(a)(2) depends, to some degree, upon classifications under State law. This is confirmed by use of the term "tort or tort type rights" in the regulations under sec. 104(a)(2).

Tennessee, the applicable jurisdiction in the diversity action filed by petitioner in the Federal District Court, recognizes a cause of action for malicious prosecution of a civil proceeding. *Ryerson v. American Surety Co. of New York*, 213 Tenn. 182, 373 S.W.2d 436, 437 (1963); *Priest v. Union Agency*, 174 Tenn. 304, 125 S.W.2d 142, 144 (1939). The elements of this tort "are that a prior suit or judicial proceeding has (1) been instituted and finally determined in favor of the plaintiff, (2) brought through malice on the defendant's part, and (3) without probable cause." *Kauffman v. A.H. Robins Co.*, 223 Tenn. 515, 448 S.W.2d 400, 402 (1969). See 4 Restatement, Torts 2d, sec. 674 (1977). Although for historical reasons, the action for malicious prosecution developed as a distinct tort, its similarity to an action for defamation is inescapable. W. Prosser, Law of Torts 834 (4th ed. 1971). Both actions allow for recovery for injury to reputation. 3 Restatement, Torts 2d, sec. 58(b) (1977), and accompanying comments.

Based upon our review of Tennessee law, we conclude that an action for malicious prosecution would be classified as an action for personal injuries. Tennessee law fixes at 1 year the applicable period of limitations for "personal tort actions" including "Actions for libel, for injuries to the person, false imprisonment, [and] malicious prosecution." Tenn. Code Ann. sec. 28-3-104 (1980). In interpreting the above statute, the Supreme Court of Tennessee held that the 1-year statute of limitations was intended to cover "actions brought for injuries resulting from invasions of rights that inhere in man as a rational being, that is, rights to which one is entitled by reason of being a person in the eyes of the law." *Brown v. Dunstan*, 219 Tenn. 291, 409

S.W.2d 365, 367 (1966) (quoting *Commerce Oil Refining Corp. v. Miner*, 98 R.I. 14, 199 A.2d 606 (1964)).

In conclusion, we emphasize that the question of interpretation presented by the language of section 104(a)(2) presents conceptual challenges. We also recognize that focusing upon the nature of the taxpayer's injury instead of the nature of the consequences flowing from that injury will often be difficult. However, this is no more difficult in most cases than the type of inquiry previously required by the line of cases, culminating in *Roemer*, which distinguished the nature of the consequences resulting from a claim. Furthermore, the approach that we will now apply in all cases, whether the injury claimed is personal, more accurately reflects the inquiry required by the plain meaning of the statute. Exclusion under section 104 will be appropriate if compensatory damages are received on account of any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law.[7] Therefore, based upon all the facts and circumstances in this case, including the nature of an action for malicious prosecution under Tennessee law, we conclude that all of the compensatory damages received by petitioner in settlement of his claim for malicious prosecution, including those allocated by the settlement agreement as compensation for injuries to professional reputation, are excludable from gross income under section 104(a)(2).

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, CHABOT, NIMS, PARKER, WHITAKER, SHIELDS, HAMBLEN, COHEN, CLAPP, JACOBS, WRIGHT, PARR, WILLIAMS, and WELLS, *JJ.*, agree with the majority opinion.

KÖRNER, SWIFT, and GERBER, *JJ.*, did not participate in the consideration of this case.

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[7] Although a corporation is treated as a "person" for many purposes, it is, nonetheless, a business entity and not a human being. We do not suggest that a corporation could avail itself of the exclusion granted by sec. 104(a)(2). See *Roemer v. Commissioner*, 716 F.2d at 699 n. 4.

SIMPSON, *J.*, dissenting: In my opinion, the Court has, by its decision today, eliminated the word "personal" from the description of the injuries for which damages are excludable under section 104(a)(2). Many cases involve difficult questions of distinguishing between personal and business injuries and the damages attributable to them. Often, in close cases, hard lines must be drawn, but because of the way the issue is presented in this case, we are not required to draw a fine line between a personal and a professional injury. Here, we are asked to decide whether damages which are admittedly for injury to a professional reputation are excludable as a personal injury.

In *Roemer v. Commissioner*, 79 T.C. 398 (1982), revd. 716 F.2d 693 (9th Cir. 1983), the taxpayer was defamed, and the defamation affected him personally and professionally. There can be reasonable differences of opinion over whether defamation is a personal injury and over whether the claim should be classified as one for personal injury in view of the consequences to both the personal and professional reputations. Yet, we are presented with no similar difficulties in this case.

Here, the petitioner was awarded substantial damages for his personal injury, and no doubt the parties have agreed that those damages are excludable under section 104(a)(2). He also was awarded damages for injury stated to be to his professional reputation. Thus, there is no question over whether these damages are attributable to a personal injury. If the words of section 104(a)(2) have any meaning, they surely do not permit the exclusion of damages declared to be for injury to a professional reputation.

TERENCE H. MURPHREE AND MARY V. MURPHREE, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 1000-85. Filed December 8, 1986.

Held, the disallowance of a refundable energy credit under sec. 48(a)(10), I.R.C. 1954, is a deficiency under sec. 6211(a).

James V. Looby, for the petitioners.
Joseph T. Chalhoub, for the respondent.

OPINION

STERRETT, *Chief Judge*: This case was assigned to Special Trial Judge Carleton D. Powell pursuant to the provisions of section 7456(d) (redesignated as section 7443A by the Tax Reform Act of 1986, Pub. L. 99-514, section 1556, 100 Stat. 2754) and Rule 180 et seq.[1] The Court agrees with and adopts the opinion of the Special Trial Judge, which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

POWELL, *Special Trial Judge*: This case is before the Court on respondent's motion to dismiss for lack of jurisdiction and to strike as to the refundable business energy investment tax credit issue filed May 17, 1985. The issue is whether this Court has jurisdiction over respondent's disallowance of a credit under section 48(a)(10),[2] relating to boilers fueled by oil or gas for investment in so-called energy property.

On their 1979 Federal income tax return, petitioners claimed a credit in the amount of $10,000. This credit arises from the alleged investment in qualifying property by Tinstaafl Corp., an electing subchapter S corporation of which petitioners were shareholders. Under section 48(e) the credit flows through to the shareholder on an apportioned basis. By a notice of deficiency dated October 19, 1984, respondent determined a deficiency in the amount of $10,927.75. The underlying adjustments in that notice are not related to the $10,000 credit that is in dispute here, and the disallowed credit does not appear in the computation of the deficiency. The notice of deficiency, however, contained a statement that "Prepayment to credits in the amount of $10,000 have been assessed for the 1979 tax year." It is agreed that this statement refers to the credit in dispute.

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[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise noted.

[2] Sec. 48(a)(10) as involved in this case was added to the Code by the Energy Tax Act of 1978, Pub. L. 95-618, and was repealed by the Tax Reform Act of 1986, Pub. L. 99-514.

On January 14, 1985, petitioners filed a petition with this Court. In the petition, petitioners allege, inter alia, that respondent erred by disallowing the $10,000 "refundable business energy investment tax credit." Respondent subsequently filed the motion to dismiss and to strike those portions of the petition that related to respondent's disallowance of the refundable energy credit.

The jurisdiction of the Tax Court is generally limited to redetermining the correct amount of a deficiency. Sec. 6214(a).A deficiency is "the amount by which the tax imposed by subtitle A" exceeds the "amount shown as the tax" on the return plus any "amounts previously assessed * * * as a deficiency" less any "rebates." Sec. 6211(a).[3] Rebates include any "abatement, credit, refund, or other repayment as was made on the ground that the tax imposed by subtitle A * * * was less than’ the tax shown on the return. Sec. 6211(b)(2). If an adjustment to a taxpayer's tax liability is based on a "mathematical or clerical error," the notice of such an adjustment "shall not be considered as a notice of deficiency," and the taxpayer generally has no right to review by this Court. Sec. 6213(b)(1). Furthermore, section 6211(b) specifically excludes certain tax credits from the determination of the tax imposed by subtitle A. For example, credits under section 31 for taxes withheld are not included in the computation of a deficiency. See sec. 6211(b)(1). The applicable regulations also provide "Payments on account of estimated income tax, like other payments of tax by the taxpayer, shall likewise be disregarded in the determination of a deficiency." Sec. 301.6211-1(b), Proced. & Admin. Regs. Neither section 6211(b) nor the regulations thereunder, however, specifically address the credit involved here.

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[3] SEC. 6211(a). IN GENERAL.—For purposes of this title in the case of income, estate, and gift taxes imposed by subtitles A and B and excise taxes imposed by chapters 41, 42, 43, 44, and 45, the term "deficiency" means the amount by which the tax imposed by subtitle A or B, or chapter 41, 42, 43, 44, or 45 exceeds the excess of—

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) the amount of rebates, as defined in subsection (b)(2), made.

Respondent concedes that, if the credit were a nonrefundable credit under section 38, the disallowed credit would be at issue in the statutory notice. See *Martz v. Commissioner*, 77 T.C. 749 (1981). To understand the position taken by respondent, it is necessary to describe the nature of the section 38 credit in dispute. The utilization of most section 38 credits is limited to the tax liability for the taxable year. See secs. 46(a)(3) and 46(a)(4); S. Rept. 95-529, 1978-3 C.B. (Vol. 2) 199, 263. A credit for qualified "solar or wind energy property," however, to the extent that it exceeds the tax liability for the year, is refundable. See sec. 46(a)(10); S. Rept. 95-529, 1978-3 C.B. (Vol. 2) 199, 263-264. In discussing refundable credits, we have noted (*Huntsberry v. Commissioner*, 83 T.C. 742, 746 n. 4 (1984)):

> the word "refundable" in this context generally refers to *credits which are really not "credits" in the ordinary sense, but reflect payments already made (or amounts available for payments) that are allocable to the tax, such as the familiar quarterly payments of estimated tax, withholding, and the like. Such "credits" are separately shown on the Form 1040 for 1979 as "Payments" that are applicable to discharge pro tanto the tax liability as finally computed on the return after taking the ordinary allowable credits into account.* They are called refundable "because the amounts involved would be available as refunds to the taxpayer in any event." H. Rept. 95-1445, at 123 (1978), 1978-3 C.B. (Vol. 1) 181, 297. See sec. 6401(b), I.R.C. 1954. The term "nonrefundable" is used to refer to all the familiar credits such as the foreign tax credit, the investment credit, the jobs credit, and other credits of like general character. No refund is available in respect of such credits even if they should exceed the tax. [Emphasis added.]

Respondent argues that, since the refundable credit here is in the nature of a payment on account, it should be disregarded in the determination of the deficiency.

If provisions discussed above were the end of the statutory story, there would be a certain amount of force behind respondent's argument. Section 46(a)(10)(C)(ii), however, provides that, with regard to the refundable energy credit for solar or wind energy property:

> for purposes of this title (*other than* * * * chapter 63), such credit shall be treated as if it were allowed by section 39 and not by section 38. [Emphasis added.] [4]

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[4] Sec. 39 provides a credit for certain uses of gasoline. The section was redesignated as sec. 34 by sec. 471(b), Deficit Reduction Act of 1984, 98 Stat. 825.

Section 6211(a), defining a deficiency, is a part of chapter 63.

Respondent, ignoring the parenthetical phrase "other than * * * chapter 63" in section 46(a)(10)(C)(ii), contends that section 6201(a)(4)[5] yokes credits under section 39 to the exception for mathematical errors and, therefore, the refundable energy credit may be assessed without regard to the notice of deficiency requirement. We, however, cannot ignore the clear language of section 46(a)(10)(C)(ii). See *Huntsberry v. Commissioner*, 83 T.C. at 747-748. The import of that language is that for the purpose of the deficiency procedures, the refundable energy credit for solar or wind energy property shall be treated as arising under section 38 and not section 39.[6]

Respondent argues that, if the parenthetical phrase "other than * * * chapter 63" is given effect, the remainder of section 46(a)(10)(C)(ii) is meaningless because the only reason for treating the credit "as if it were allowed under section 39"is that it could be assessed as a section 39 credit. We disagree. There are provisions, other than those contained in chapter 63, where a section 39 credit is treated differently from section 38 credits. Section 6401(b), which is not in chapter 63, provides that "If the amount allowable as * * * [a credit] under * * * section 39 * * * exceeds the tax imposed by subtitle A (reduced by the credits allowable under * * * [sections 32, 33, 37, 38, 40, 41, 42, 44, 44A, 44B, 44C and 45]), the amount of such excess shall be considered an overpayment." That provision makes credits governed by section 39 refundable. It is certainly within the power of Congress to make respondent's challenge to certain refundable credits subject to the deficiency proce-

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[5] Under sec. 6201(a)(4), if there is an overstatement of a credit allowable by sec. 39, the amount so overstated may be assessed "in the same manner as in the case of a mathematical or clerical error." As noted, *supra* sec. 6213(b)(1) provides an exception to the notice of deficiency requirement for so-called "mathematical or clerical" errors. Under this exception, if such an error is made, notice of the error is not considered a notice of deficiency, the prohibition against assessment does not arise and the tax may be assessed immediately. See *Beckman v. United States*, 396 F. Supp. 44 (D. Kan. 1975), affd. in an unpublished opinion (10th Cir., Jan. 7, 1977). While Congress added a mechanism for review of respondent's determination of a mathematical or clerical error by the Tax Court by enacting sec. 6213(b)(2), sec. 6201(a)(4) also was amended to provide that "the provisions of section 6213(b)(2) * * * shall not apply with regard to any assessment under this paragraph."

[6] Respondent places emphasis on the fact that the credit is claimed in the "Payments" section of the 1979 Form 1040. Even if this is correct, the form and/or instructions do not have the force of law.

dures while others are not. Indeed, Congress specifically provided in chapter 63 that in certain situations, a disallowed section 39 credit would be an aspect of the computation of a deficiency and subject to review by this Court. See sec. 6211(b)(4).[7]

In sum, we hold that the refundable energy credit at issue here is treated as a credit under section 38 for the purposes of chapter 63. Accordingly, the result in this case is controlled by our opinion in *Martz v. Commissioner*, *supra*, and respondent's motion must be denied.

An appropriate order will be issued.

LINWOOD CEMETERY ASSOCIATION, AN IOWA NON-PROFIT CORPORATION, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 3093-86X. Filed December 17, 1986.

P is a corporation which operates a cemetery. It was organized in 1875 to take over the operation, by the City of Dubuque, Iowa, of the city cemetery. It has tax-exempt status as a cemetery company under sec. 501(c)(13), but seeks, in addition, to be classified as exempt under sec. 501(c)(3), I.R.C. 1954, as a "charitable" organization. It has substantially increased the size of the cemetery and expanded its operation since its founding in 1875. In its cemetery operations, P engages in the sale of burial services, plots, markers, evergreens, crypts, vaults, and perpetual and special care services. It maintains a potter's field, and provides "free burials" to veterans and to indigents. *Held*: P does not qualify under sec. 501(c)(3). It not only is not operated "exclusively" for exempt purposes by reason of its substantial nonqualifying sales and cemetery maintenance activities, but also its charitable activities do not represent the "principal" purpose for carrying on its entire operation.

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[7] **SEC. 6211(b). RULES FOR APPLICATION OF SUBSECTION (a).—For purposes of this section—**

* * * * * * *

(4) The tax imposed by subtitle A and the tax shown on the return shall both be determined without regard to the credit under section 39, unless, without regard to such credit, the tax imposed by subtitle A exceeds the excess of the amount specified in subsection (a)(1) over the amount specified in subsection (a)(2).

Brian J. Kane, for the petitioner.
Judith M. Picken, for the respondent.

OPINION

RAUM, *Judge*: The Commissioner determined that petitioner does not qualify for exemption from income taxation as an organization described in section 501(c)(3), I.R.C. 1954. Petitioner has invoked the jurisdiction of this Court to obtain a declaratory judgment as to its exempt status under section 501(c)(3). [1] The question presented is whether petitioner is operated exclusively for charitable purposes within the meaning of section 501(c)(3), I.R.C. 1954.

The case was submitted on the basis of the stipulated administrative record, which is incorporated herein by reference. The factual representations in the administrative record are accepted as true. Rule 217(b), Tax Court Rules of Practice and Procedure.

The Linwood Cemetery Association (hereinafter petitioner, Linwood, or the association) is an Iowa nonprofit corporation with its office located in Dubuque, Iowa. It was originally incorporated on August 25, 1875. It filed restated articles of incorporation on November 19, 1976, when it elected to "voluntarily adopt the provisions of the Iowa Nonprofit Corporation Act." The association was granted tax-exempt status on April 10, 1942, under the predecessor of section 501(c)(13), I.R.C. 1954. Its status under section 501(c)(13) is not now at issue.[2] Petitioner filed with the Internal Revenue Service a Form 1023 "Application for Recognition of Exemption Under Section 501(c)(3)" dated

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[1] The jurisdictional requirements specified in sec. 7428, I.R.C. 1954, have been satisfied; petitioner is the organization whose exempt status is in issue; it has exhausted its administrative remedies; and this action was timely filed. Sec. 7428(b), I.R.C. 1954; see Rule 210(c), Tax Court Rules of Practice and Procedure.

[2] Sec. 501(c)(13) confers exempt status upon cemetery companies which meet one of three following independent requirements:

(1) "owned and operated exclusively for the benefit of their members;" (2) "not operated for profit;" or (3) "chartered solely for the purpose of the disposal of bodies by burial or cremation which is not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual."

See *Rockefeller Family Cemetery Corp. v. Commissioner*, 63 T.C. 355, 358 (1974); *Washington Park Cemetery Association, Inc. v. Commissioner*, T.C. Memo. 1963-268.

March 9, 1984.[3] The Commissioner issued a final adverse determination on December 30, 1985. The petition for declaratory judgment (exempt organization) was filed with this Court on February 3, 1986.

Linwood Cemetery Association was founded in 1875 in order to deal with the problem of the unsatisfactory state of the burial grounds existing at that time in Dubuque, Iowa (the city or Dubuque). By the time the association was founded, the city had established a cemetery on the present site of the Linwood Cemetery, a site removed from the city. This cemetery replaced one located in the center of town that had fallen into disrepair and became the scene of street arguments and "disrespect of the dead". Under the city's care, the cemetery that had been established on the Linwood site in turn fell into disrepair. It became overgrown with brush, weeds, briers, and bramble. There were no suitable pathways through it and monuments were hidden from view.

The Linwood Cemetery Association was founded by 19 prominent citizens of Dubuque who raised $60,000 in stock subscriptions from 113 investors. They incorporated the association and "pushed the City Council to [hold] a citywide vote in October, 1875," on the issue of the management of Linwood Cemetery. The result of that vote, held on October 1, 1875, was that "the legal and certified voters of the City of Dubuque did * * * by a majority of all the votes cast, vote in favor of selling the lands owned by the City used and known as Linwood Cemetery" to the association. The vote was 697 for and 308 against such sale.

The cemetery property extending over some 39 acres was sold by the city to the association by deed dated October 7, 1875. As consideration for the sale, the city received "One Dollar" and imposed on the association the "covenants and conditions" set out in the deed. Relevant portions of the conditions of the sale found in the deed are as follows:

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[3] Petitioner seeks tax-exempt status under sec. 501(c)(3), I.R.C. 1954, in order to assure that bequests made to Linwood will be deductible from the donor's gross estate under sec. 2055(a)(2). Although sec. 170(c)(5), I.R.C. 1954, provides for a deduction for income tax purposes in the case of a contribution by an individual to a "cemetery company", no such parallel provision exists for estate tax purposes in respect of such contributions. See *Child v. United States*, 540 F.2d 579, 581-582 (2d Cir. 1976), cert. denied 429 U.S. 1092 (1977).

> 1st The Conveyance is made subject to all lots that have already been conveyed in said premises.
>
> 2d The said Grantees herein agree and bind themselves to take charge in place of the City of the entire Cemetery conveyed, to keep the same in proper order and condition; to keep down weeds brush, and brambles on all unsold ground; to furnish Sexton; to keep up and maintain a proper fence around the Cemetery grounds with the necessary gates for ingress and egress * * * .
>
> 3rd As to the Potters field, * * * the Grantees herein agree to retain the same for the same purpose, or to furnish elsewhere in the old cemetery, or on the land bought by the Grantees for the New Cemetery, an equal amount of land for said Potters field and at such time as more land may be required for a Potters field the said Grantees agree to furnish the same to the Cemetery free of charge, or at some other proper location convenient to the City and satisfactory to the City Council. And no cost or expense shall be charged to the City for digging a grave for or taking charge of the burial of any corpse in the said Potters field.
>
> 4th The Lots already sold in the lands hereby conveyed are in no wise to be disturbed or interfered with by the Grantees except by the consent of such lot owners, and the Grantees agree to take as good care of the said lots now sold as the City has heretofore done * * * .
>
> 5th No change of grade shall be made upon any avenue, road or alley of said present Cemetery where any lots have been sold and interments made therein abutting thereon, except by consent of at least two thirds (2/3) of such lot owners * * * .
>
> 6th The City agrees to grant to the Grantees the privilege of laying out additional Cemetery Grounds immediately North and East of the present Cemetery not exceeding three hundred acres of land. The prices which Grantees may charge for digging graves shall be Cincinnati Schedule prices: provided that for digging and enclosing an ordinary grave without walling or planking no more than three dollars shall be charged.
>
> 7th The Grantees agree to sell lots in the Cemetery as follows: 1/20th of the lots at a rate of not over ten cents per square surface foot and 1/20th at a rate not over twenty cents per square surface foot and any land that may be added by the Grantees to the Cemetery land conveyed lots shall be sold 1/20 at ten and 1/20th at not over twenty cents per square surface foot.
>
> 8th The public to have the privilege of going into the Cemetery at all reasonable hours subject to such reasonable rules and regulations as the Grantees may adopt but never, however, to be charged any entrance fee.
>
> 9th The Grantees shall provide a Sexton who shall be present at all burials and assist at the same without expense to lot owners. He shall keep a record of all burials with the name and age of the deceased if known and also of the disease that caused the death if known. * * *

The deed further provided that "Any intentional failure on the part of the Grantees to substantially perform and carry out the foregoing conditions shall work a forfeiture of this conveyance to the City of Dubuque with all improvements made thereon". There is no longer a city-run cemetery in Dubuque, Iowa.

Relying on the circumstances of its origin and the covenants and conditions contained in the above deed, Linwood considers itself to be "an outgrowth of the City of Dubuque".

The cemetery run by Linwood is a fully operational cemetery, which conducts an average of 150 burials per year and is located on approximately 140 acres of property, substantially in excess of the 39 acres on which the cemetery was operated when it was conveyed to the association in 1875. Its location provides it with space on which to operate "for at least 1,000 more years." Linwood's restated articles of incorporation outline "The purpose or purposes for which the corporation is organized" as follows: "to operate, conduct and maintain in or near the City of Dubuque, Iowa a cemetery or cemeteries for the interment of the dead". Petitioner's Form 1023, application for recognition of exemption, contains the following description of the activities it carries on:

> Linwood serves a community need by operating a non-profit cemetery which sells land (plots), mausoleum crypts and memorials. Linwood also provides perpetual care services, special care and free burial to indigents of the City and County of Dubuque as well as to Veterans.

The services it furnishes are further described in an affidavit filed in the administrative record by the general manager of the association as follows:

> 1. Does not deny burial to any person on account of race, creed, color or ethnic origin;
>
> 2. Provides free burial *space* for all honorably discharged veterans [emphasis supplied];
>
> 3. Provides a "potters field" or county section and furnishes *space* for all indigents *to be buried free of charge* [emphasis supplied];
>
> 4. Provides an average of 150 burials per year;
>
> 5. Sells land, mausoleum crypts and memorials;
>
> 6. Provides perpetual care;
>
> 7. Places Christmas wreaths in Cemetery at Christmastime;
>
> 8. Provides special care which includes planting of flowers on property owners lots and trimming of schrubs [sic];
>
> 9. Plats [sic] flower beds throughout the Cemetery for beautification during the season;

10. Transports elderly people to the Cemetery upon request for visitation;
11. Provides tours for school groups which are guided by Linwood personnel who explain points of interest;
12. Promotes and allows the Bird Watchers Association to meet periodically throughout the season at the Cemetery;
13. Provides school children with information for school and community studies;
14. Provides information for the Genealogy Society;
15. Provides Memorial Day services for the public with speakers, bank [sic] and memorial service;
16. Provides the Avenue of Flags flown for the public on Memorial Day weekend, Flag Day and the Fourth of July;
17. Provides small flags for persons to place on Veterans graves; and
18. Provides families throughout the Dubuque area with a booklet called the "Family Emergency Portfolio Guide" to help eliminate hardship at time of death (these are delivered to families and explained free of charge before tragedies occur in their homes).

In the years 1980 through 1983, the number of free burials[4] and total burials conducted at Linwood Cemetery each year is as follows:

	1980	*1981*	*1982*	*1983*	*1980-83*
Free burials	91	77	71	79	318
Paid Do.	59	88	72	73	292
Total Do.	150	165	143	152	610

The percentage of total burials which were free burials in 1980, 1981, 1982, and 1983 is 60.66 percent, 46.66 percent, 49.65 percent, and 51.97 percent, respectively. Overall, in the 4 years, free burials constituted just over half (52.13 percent) of total burials.

The association's restated articles of incorporation provide that "No part of the net earnings of the corporation shall inure to the benefit of or be distributable to directors, officers, or other private persons, except that the corporation shall be authorized to pay reasonable compensation for services rendered, and to make payments and distributions in furtherance of its purposes". The articles further provide that "No substantial part of the activities of the corporation shall be carrying on of propaganda or otherwise attempting to influence legislation, and the corporation shall not participate in, or intervene in (including the publishing or distribution of statements) any political campaign on behalf of any candidate for public office". Additionally, the association is expressly prohibited from "carry[ing] on any other activities not permitted to be carried on (a) by a corporation exempt from federal income tax under Section 501(c)(3) * * * or (b) by a corporation, contributions to which are deductible under Section 170(c)(2) of the Internal Revenue Code of 1954". On "dissolution of the corporation", its board of directors is instructed to pay the corporation's liabilities and then "dispose of all the assets of the corporation exclusively for the purpose of the corporation in such manner, or to such organization or organizations, organized and operated exclusively for charitable, educational, religious or scientific purposes as shall at the time qualify as an exempt organization or organizations under Section 501(c)(3) of the Internal Revenue Code of 1954".

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[4] It is unclear from the record whether this "free burials" category includes burials in which only the burial space is provided free of charge or whether it includes burials in which both the space, interment, and associated services are provided free of charge. The limiting language of the above affidavit (at numbers 2 and 3) and similar language in another exhibit in the administrative record raise troubling doubts in this connection, especially with respect to the "free burial" of veterans. Further, while the Government pointed out this ambiguity in its opening brief, petitioner made no effort, in its reply brief, to clarify the situation.

The association's bylaws provide that "The corporation shall have no members". They provide for a 12-member board of directors and a president, secretary, recording secretary, treasurer, and general manager.[5] Provision is made for an executive committee to manage the affairs of the corporation and for two standing committees which are the committee of sales and the committee of finance and audit.

In its application for recognition of exemption, Linwood represented that its "largest source of financial support results from the operation, conduct and maintenance of the non-profit cemetery". The source and amount of petitioner's gross revenues for the years 1980 through 1983 are as follows:

	1980	*1981*	*1982*	*1983*
Operations	$176,325.49	$191,880.41	$210,827.40	$165,847.6
Investments	40,384.19	44,394.89	58,676.86	54,770.0
Gifts	6,495.00	3,906.12	2,794.36	3,365.0
Total revenues	223,204.68	240,181.42	272,298.62	223,982.7

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[5] How the board of directors and the officers are selected is not clear from the record.

Revenues from operations comprised 79 percent, 79.89 percent, 77.43 percent, and 74.05 percent of total gross revenues in 1980, 1981, 1982, and 1983, respectively, while revenues from gifts comprised only 2.91 percent, 1.63 percent, 1.03 percent, and 1.5 percent of total revenues in those same years.

The gifts received were made, at least in part, in response to Linwood's annual Christmas solicitation for financial support. That solicitation states that "For many, Linwood is more than a cemetery and is an integral part of Dubuque and its proud heritage" and that "your help however remains increasingly vital". It asks the potential donor to "be a part of [the Linwood] heritage".

The association's bylaws provide for the maintenance of a "General Operating Account", an "Account for Non-Restrictive Funds" supplied by the deposit of investment assets, and three special purpose trusts. The special purpose trusts include a "Perpetual Care Fund Trust" funded by "Twenty percent (20%) of all land and marker sales" and a "Special Care Fund Trust" endowed by "special donations". Both the funds supplied to the Perpetual Care and those supplied to the Special Care Fund Trusts are shown on Linwood's income statements for 1980 through 1983 as "Income Reserves" offset against "Income-Operations". The final special trust provided for in the bylaws is the "Ella B. Ruete Memorial Trust Fund" to which expenses for the upkeep of two particular grave areas are charged. In the years 1980 through 1983, these three funds were carried on petitioner's balance sheets in amounts ranging from $438,402 to $468,181 and they produced "Investment Income" in amounts ranging from $36,559 to $50,445.52. Total association assets[6] in those years ranged from $715,955 to $1,094,705.[7]

Expenditures made by Linwood in 1980 through 1983 consisted of its cost of sales and the operating expenses (wages, commissions, utilities, advertising, taxes) typical of an ordinary business. Its expenses which are attributable to

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[6] Petitioner carried the cemetery land on its books at its cost of $1.

[7] In 1980, 1981, and 1982 total assets were $732,388.40, $715,955.29, and $768,873.81. Only in 1983, with the appearance of a "Memorial Chapel Fund" did assets reach over $1 million.

"free burial" of indigents and veterans are not segregated from those attributable to other burials.

The sums allocable to the above described items of income and expense are set forth in the following summary based upon petitioner's income statements for the years 1980 through 1983:

	1980	*1981*	*1982*	*1983*
Revenue:				
Operations and gifts	$182,820.49	$195,786.53	$213,621.76	$169,212.8
Less:				
Special trust reserve	14,638.00	13,444.60	16,916.20	12,687.9
Cost of sales	34,735.34	43,588.46	36,533.58	34,288.
Gross profit	133,447.15	138,753.47	160,171.98	122,236.2
Less:				
Operating expenses	155,129.91	173,365.86	185,643.65	166,582.1
Operating income	(21,682.76)	(34,612.39)	(25,471.67)	(44,345.8
Investment and other income	40,384.19	44,394.89	59,957.30	55,807.4
Net income	18,701.43	9,782.50	34,485.63	11,461.5

In the final adverse determination of petitioner's status under section 501(c)(3), the Commissioner simply stated, as the reason for the determination, that "The organization is not operating exclusively for the purposes under section 501(c)(3)". Petitioner contends that it is "operated exclusively for charitable purposes since the functions it performs, * * * would [otherwise] descend upon the public". The association also apparently relies on a characterization of its activities as pursued for "relief of the poor and distress[ed] or of the underprivileged" and to further "public health" in its argument for section 501(c)(3) status. These "relief of the poor" and "public health" bases for exempt status seem to be treated by petitioner as subsumed within its argument that its function would otherwise "descend upon the public."[8] Petitioner further asserts that it "is not denied charitable status simply because it charges for its services".[9]

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[8] Our uncertainty with respect to the arguments made by petitioner in this Court is a result, in large part, of petitioner's having relied in its brief on "the arguments advanced by Linwood * * * in [unspecified portions of] the Administrative Record." While we do not look upon petitioner's mere reference to arguments made in the administrative record as a proper briefing of the issues, we have strained to consider all petitioner's arguments even if only vaguely alluded to on brief.

[9] In the administrative record, petitioner also makes an argument based on unconstitutionality under the Fifth Amendment of the distinction, for purposes of exemption, between church cemeteries and other nonprofit cemeteries. Petitioner does not mention that line of argument

As noted earlier herein, petitioner was granted an exemption from taxation in 1942 under the predecessor of section 501(c)(13) as a "cemetery company", and that exemption is not in controversy. It now seeks exemption also under the more rigid requirements of section 501(c)(3) as an entity "organized and operated exclusively for * * * charitable * * * purposes".[10] The Government contends initially in substance that the framework and legislative history of section 501 establish that, with some possible rare exceptions, section 501(c)(3) and section 501(c)(13) were intended to be mutually exclusive, and that petitioner as a section 501(c)(13) cemetery company is not eligible for classification as a "charitable" organization under section 501(c)(3). The argument in support of that position is strong, but we find it unnecessary to pass upon it because of our conclusion that petitioner in any event fails to qualify under section 501(c)(3).

The Commissioner argues that petitioner is more suited to classification under section 501(c)(13) than under section 501(c)(3), I.R.C. 1954, because the "association does not lessen the burdens of Government", its activities do "not amount to relief of the poor", and its "non-charitable functions are not merely incidental". The burden is on petitioner to show, based on the administrative record, that the Commissioner erred in his determination that Linwood is "not operating exclusively for the purposes under section 501(c)(3)". *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 356 (1978); *Hancock Academy of Savannah v. Commissioner*, 69 T.C. 488, 492 (1977).

Petitioner may qualify for exempt status under sections 501(a) and (c)(3) only if it is "*both* organized and operated

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on brief. In any case, the argument must be rejected on the basis of *First National Bank of Omaha v. Commissioner*, 681 F.2d 534, 541 n. 5 (8th Cir. 1982), cert. denied 459 U.S. 1104 (1983).

[10] Although classification under sec. 501(c)(3) rather than under sec. 501(c)(13) would not improve its own tax-exempt status, it could enhance its funding position. To be sure, a contribution to a cemetery company like petitioner would probably be deductible by the donor for income tax purposes pursuant to sec. 170(c)(5), and petitioner's sec. 501(c)(13) exempt status would thus be just as useful to it in respect of inter vivos contributions as its desired exempt classification under sec. 501(c)(3). But the situation is sharply different in respect of testamentary bequests, because there is no corresponding provision in the Code granting estate tax deductions for gifts to "cemetery companies". See *Child v. United States*, 540 F.2d 579, 582 (2d Cir. 1976), cert. denied 429 U.S. 1092 (1977). However, if such companies could also qualify as being governed by sec. 501(c)(3), there would be a basis for an estate tax deduction under sec. 2055(a)(2) or (3).

exclusively for one or more of the [exempt] purposes" listed in section 501(c)(3). (Emphasis supplied.) Sec. 1.501(c)(3)-1(a)(1), Income Tax Regs. It is only whether petitioner is "operated exclusively" for those tax-exempt purposes that is at issue here. No question is here presented as to whether it was "organized" for such purposes—a question that could well be answered in petitioner's favor.

To qualify for exemption under section 501(c)(3), petitioner must show that it was "organized and operated *exclusively* for * * * charitable * * * purposes". The word "exclusively" is a critical term. In this connection, we stated in *Copyright Clearance Center v. Commissioner*, 79 T.C. 793, 804 (1982):

> While it is true that the word "exclusively" has not been given a literal interpretation, and that a nonexempt purpose even perhaps somewhat beyond a de minimis level has been permitted without loss of exemption, it is nevertheless plain that the word "exclusively" places a definite limit on the "purpose" at issue. * * * [Fn. ref. omitted.]

And in that case we called attention to the limit placed on that word by the Supreme Court in *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945), as follows:

> the presence of a single [nonexempt] * * * purpose, *if substantial in nature*, will destroy the exemption regardless of the number or importance of truly [exempt] * * * purposes.

We also called attention in *Copyright Clearance Center* (p. 804) of our awareness "that in some cases the test has been restated in terms of 'whether an organization's *primary* purpose is exempt or nonexempt.' (Emphasis supplied.) See *est of Hawaii, Inc. v. Commissioner*, 71 T.C. 1067, 1079 (1979), affd. 647 F.2d 170 (9th Cir. 1981); cf. *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 357 n. 2 (1978)". Irrespective of whether there may be any real differences between these two formulations, it is our conclusion that petitioner fails to satisfy either.[11]

Accordingly, petitioner must demonstrate that its cemetery operation is conducted to further no single nonexempt purpose of a substantial nature. While the association has suggested numerous charitable purposes which it pursues in its cemetery operation, these charitable purposes explain only a portion of its activities. As to the remainder of its activities, we find that petitioner has not shown with what purpose they are pursued and we can conclude only that petitioner has not met its burden of proving that they were not pursued with a substantial nonqualifying purpose. Petitioner's failure in this regard is critical because the existence of a substantial nonqualifying purpose is fatal to the claimed exemption "regardless of the number or importance of truly [exempt] * * * purposes". *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945).

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[11] Of course, if there should be a difference in result in the application of these two "tests", the one stated by the Supreme Court must obviously govern.

The association suggests, in the administrative record and on brief, that in operating the cemetery its purposes are to lessen the burden of Government, to relieve the poor, and to promote public health. We agree that Linwood, in providing free burials or burial space to veterans[12] and to indigents,[13] lessens the burdens of Government and relieves the burden of the poor. Further, its performance of burial services can be regarded as an activity promoting public health since it "insures that society is not subject to disease from decomposing human remains". *First National Bank of Omaha v. Commissioner*, 681 F.2d 534, 537 (8th Cir. 1982), quoting *Estate of Edwards*, 88 Cal. App. 3d 383, 151 Cal. Rptr. 770 (1979).

However, the interment of the dead and the provision of free burial space to veterans and to indigents do not constitute petitioner's entire operation. Instead, petitioner also sells plots, markers, evergreens, crypts, vaults, and perpetual and special care services. These sales activities are certainly not conducted in order to relieve the poor or to promote public health. Rather, they are carried on by petitioner in the manner of a commercial enterprise and seemed to be pursued with ordinary "cemetery purposes" rather than with charitable purposes. See *Estate of Amick v. Commissioner*, 67 T.C. 924, 928, 930 (1977); *Wilber National Bank v. Commissioner*, 17 B.T.A. 654, 661 (1929).

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[12] Federal law gives veterans and their spouses the privilege of burial in national cemeteries without charge. 38 U.S.C. sec. 1002 (1982).

[13] Iowa law provides for the delivery to specific medical colleges of "The body of every person dying in a public asylum, hospital, county care facility, penitentiary, or reformatory in this state, or found dead within the state or which is to be buried at public expense in this state". However, exception is made for those entitled to funeral expenses "under the [state supplemental assistance] provisions of chapter 249" and "if the deceased person expressed a desire during his last illness that his body should be buried or cremated". Iowa Code Annotated sec. 142.1 (West 1986). The expense of such a burial is "paid out of the poor fund of the county in which [the deceased] had a legal settlement". Op. Iowa Atty. Gen. 276, 277 (1928).

Cemetery activities of this sort have not in the past been found to be of a charitable nature. Cf. *Child v. United States*, 540 F.2d 579, 582-584 (2d Cir. 1976), cert. denied 429 U.S. 1092 (1977); *Gund's Estate v. Commissioner*, 113 F.2d 61 (6th Cir. 1940), affg. a Memorandum Opinion of this Court, cert. denied 311 U.S. 696 (1940); *Estate of Amick v. Commissioner*, 67 T.C. 924 (1977); *Wilber National Bank v. Commissioner*, 17 B.T.A. 654 (1929); *Estate of Haley v. Commissioner*, a Memorandum Opinion of this Court dated September 30, 1948, 7 T.C.M. 691, 17 P-H Memo T.C. par. 48,191; *Smith v. United States*, an unreported case (W.D. Mo. 1984, 55 AFTR 2d 85-1548), 84-2 USTC par. 13,595; Rev. Rul. 67-170, 1967-1 C.B. 272. Petitioner has not provided us with any basis for finding that its purposes in engaging in these activities are any different from those of the cemeteries in the foregoing line of cases.

Petitioner relies heavily in seeking section 501(c)(3) status on its contention in substance that all of its activities are carried on for the purpose of lessening the burden of Government. In making this argument, the association assumes that the entire operation of the Linwood Cemetery, including those activities hereinbefore characterized as nonexempt, is a burden of Government. This assumption presumably stems from the circumstance that Linwood Cemetery was once a city cemetery and the association was organized to take over that city cemetery. However, in asserting that its activities lessen a burden of Government because it was organized to take over a Government enterprise, Linwood assumes too much. It assumes that the fact that it was *organized*, in 1875, to lessen a burden of Government is conclusive on the issue of whether it is *operated*, today, to lessen a burden of Government. It is clear that petitioner must be "*both organized and operated* exclusively for" (emphasis supplied) exempt purposes, section 1.501(c)(3)-1(a)(1), Income Tax Regs., and that the purpose of its initial founding goes primarily to the former and not to the latter.

We recognize that the circumstances of petitioner's organization do indicate, first, that operating a cemetery probably was considered, at or before the time of its founding in 1875, to be a burden of Government and, second, that at that time its activities may have been pursued in order to lessen that burden of Government. And we also recognize that "the burial of the dead" was once considered to be "the exclusive province of the community". *Sherwood Memorial Gardens, Inc. v. Commissioner*, 42 T.C. 211, 229-230 (1964), affd. 350 F.2d 225 (7th Cir. 1965). At that time, when cemeteries tended to be "slow and unprofitable" community enterprises (*Sherwood* at 229), the operation of a cemetery might justifiably have been regarded as a "burden of government". However, in "modern times", when "fortunes are daily reaped from such [cemetery] activities by many private individuals", (*Sherwood* at 230), and those activities are carried on in competition with commercial enterprises, they can hardly be characterized as a burden of Government, which, if assumed by petitioner, make petitioner's activity a charitable one. We note that "What is charitable in one generation may be non-charitable in a later age", *Green v. Connally*, 330 F. Supp. 1150, 1159 (D.D.C. 1971), affd. sub nom. *Coit v. Green*, 404 U.S. 997 (1971), quoting 4 G. Bogert, Law of Trusts and Trustees, sec. 369, at 63 (2d ed. 1964). Petitioner has not convinced us that its overall cemetery operation is pursued exclusively with the charitable purpose of lessening a burden of Government.

Petitioner would also have us sweep its nonexempt sales activities in with its exempt activities by analyzing its qualification for section 501(c)(3) status under standards reserved for hospitals. It reasons that, under the standards applied to hospitals, the fact that it receives "payments for products or fees for services [would] not result in the loss of [section 501(c)(3)] charitable status". While the level of free care required of hospitals is much lower than that required of other charitable organizations, we cannot apply the less stringent hospital standards to Linwood because the rationale for so treating hospitals does not apply equally to cemeteries. Hospitals may provide a substantial portion of their services for a price and yet remain qualified under section 501(c)(3) since "the rendering of medical care is a charitable activity" in and of itself because it promote health. *Sound Health Association v. Commissioner*, 71 T.C 158, 178 (1978). See *Eastern Kentucky Welfare Right Organization v. Simon*, 506 F.2d 1278, 1287 (D.C. Cir. 1974) vacated on other grounds 426 U.S. 26 (1975); Rev. Ru 69-545, 1969-2 C.B. 117. This is true so long as the class o people treated is large enough so that the community as whole, rather than just private interests, is served. *Soun Health Association v. Commissioner*, 72 T.C. at 181. Petitioner suggests that its activities promote public health and it is clear that they do to the extent Linwood dispose of human remains so that "society is not subject to diseas from decomposing human remains". *First National Bank o Omaha v. Commissioner*, 681 F.2d 534, 537 (8th Cir. 1982) quoting *Estate of Edwards*, 88 Cal. App. 3d 383, 151 Cal Rptr. 770 (1979). However, it is equally clear that petitioner's sales of plots, memorials, evergreens, and maintenanc services are far beyond what is required to protect publi health. For this reason, and because those activities do no lessen the burdens of Government or relieve the poor, the constitute a nonexempt set of activities which is pursue with a nonexempt purpose that is "substantial in nature" and which must "destroy the exemption" sought by petitioner.

Petitioner has not convinced the Court that under th test set forth in *Better Business Bureau v. United State* 326 U.S. 279, 283 (1945), and followed by this Court i *Copyright Clearance Center v. Commissioner*, 79 T.C. 79 804 (1982), it pursues no substantial nonexempt purpos and is thereby operated "exclusively" for exempt purpose Even if the test determinative of petitioner's sectio 501(c)(3) status were reformulated to focus on whethe petitioner's "primary purpose is exempt or nonexempt" petitioner would still fail to qualify under section 501(c)(3 The evidence presented by the association which would b pertinent to this latter formulation of the test is scarce an ambiguous.

It consists of the number of free and total burial provided in the years 1980 through 1983 and the association's financial statement for those same years. This ev dence shows only that approximately one-half of the burial in 1980-83 were paid for and one-half were free, but it does not indicate the relative expenditures made on each of these categories of burials or the relative magnitude of each category of burial or of burials compared to other activities in the context of the entire operation. As hereinbefore noted (note 4) it is not even clear what goods and services are provided in a "free burial", beyond burial space.[14] To the extent that only burial space is provided in a "free burial", petitioner's provision of "free burials" might well entail only a comparatively minor burden. Given the record with respect to this issue, we are in no way convinced that petitioner's objective in carrying on its nonexempt activities (sales, maintenance, etc.) does not represent its "primary purpose", nor are we convinced that such activities are anything less than a substantial part of Linwood's operation.

Decision will be entered for the respondent.

THOMAS J. DURKIN AND COLETTE A. DURKIN,
PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

JEROME A. GROSSMAN AND SYBIL G. GROSSMAN,
PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

Docket Nos. 18885-82, 25313-82, 22937-83, 4229-84, 17602-84, 17677-84, 27623-84. Filed December 22, 1986.

D was a limited partner in B, and G was an indirect limited partner in S. PPC, a producer and distributor of major movies, sold all of its rights, except sequel rights, in six movies to FWC. FWC paid PPC cash and short-term recourse notes equal to 25 percent of the negative cost and long-term nonrecourse notes equal to 75 percent of the

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[14] Moreover, it is far from clear that even as to free burial space provided, such space was as desirable or as valuable as the space sold to paying clients. Indeed, in the absence of evidence to the contrary, it would be a fair inference that such free space was not nearly as valuable as the space that was sold.

negative cost of each movie. In 1977, on the same day it purchased two of the six movies, FWC sold them to B. In 1978, on the same day it purchased the remaining four of the six movies, FWC sold them to S. B and S paid cash and short-term recourse notes in excess of 25 percent of the negative cost and long-term recourse notes equal to 75 percent of the negative cost of each movie, but the long-term notes would become nonrecourse on the occurrence of certain specified conditions. D and G guaranteed the long-term notes. On the same days that B and S purportedly purchased their motion pictures, they executed distribution agreements with PPC, wherein they transferred all of their rights, except copyright, in such motion pictures to PPC. PPC distributed the motion pictures. S borrowed money from Delta at 9½ percent interest per annum and with bonus payments based on PPC's nontheatrical gross receipts. Such money was needed because the initial payments for the movies exceeded the capitalization of S. B and S made guaranteed payments to their general partners of both a fixed dollar amount and a percentage of cash-flow. B and S reported various deductions. D and G reported tax losses for every year through 1980, except 1979 for G, and claimed investment credits as a result of the activities of B and S. Numerous subpoenas duces tecum issued on behalf of the Commissioner were quashed. *Held*:

1. B and S did not acquire a depreciable interest in the motion pictures. They purchased, in substance, only a contractual right to payments contingent on the success of the motion pictures.

2. B and S are entitled to depreciate their bases in each such contract right.

3. B and S erred in using motion picture gross receipts when calculating depreciation under the income-forecast method.

4. B erred in not including an estimate of network television revenue when calculating depreciation under the income-forecast method, where there was an agreement but no signed contract concerning network television exhibition.

5. S could not use the double-declining-balance method of depreciation because its contract rights were intangible assets. The straight-line method must be used; useful life of such assets determined to be 6 years.

6. The long-term notes from B and S to FWC were not bona fide recourse debt and, therefore, were not includable in depreciable bases.

7. The short-term notes from B and S to FWC due prior to 1986 were bona fide recourse debt and, therefore, were includable in depreciable bases.

8. D and G are entitled to investment credit with respect to the motion pictures because B and S acquired an "ownership interest" in each of their respective films within the meaning of sec. 48(k)(1), I.R.C. 1954.

9. B and S are not entitled to deduct guaranteed payments made to their general partners.

10. B and S are not entitled to current deductions for advertising payments where such payments are found to be part of the purchase price of certain motion pictures.

11. Expenses arising from private screenings of motion pictures by S were ordinary and necessary business expenses.

12. Certain amounts deducted by B and S were for organization costs.

13. Bonus fees paid to Delta were not reasonable in amount.

14. This Court properly quashed the Commissioner's subpoenas duces tecum.

Alan F. Segal, for the petitioners in all dockets.

Calvin Eisenberg, for the petitioners in all dockets except docket No. 22937-83.

Bryan R. Sullivan and *Thomas J. Kane*, for the respondent.

SIMPSON, *Judge*: The Commissioner determined the following deficiencies in, and additions to, the petitioners' Federal income taxes:

Petitioners	*Docket Nos.*	*Year*	*Deficiency*	*Addition to tax sec. 6651(a)(1), I.R.C. 1954* [1]
Thomas J. Durkin and Colette A. Durkin	25313-82	1977	$18,642.56	---
	18885-82	1978	35,162.50	---
	27623-84	1979	33,376.74	---
	4229-84	1980	17,275.58	---
Jerome A. Grossman and Sybil G. Grossman	22937-83	1978	46,196.00	$10,513
	17677-84	1979	53,395.00	---
	17602-84	1980	13,802.00	3,450

After concessions by the parties, the issues for decision are: (1) Whether the petitioner, Thomas Durkin, as a limited partner in a partnership which purportedly owned two motion pictures, and the petitioner, Jerome A. Grossman, as an indirect limited partner in a partnership which purportedly owned four motion pictures, are entitled to deductions for distributive shares of losses reported by the partnerships, and, if so, what are the appropriate partnership deductions; (2) whether the petitioners are entitled to investment credits for their investments in such motion pictures; and (3) whether this Court erred in quashing the Commissioner's subpoenas duces tecum.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue, unless otherwise indicated.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

The petitioners, Thomas J. and Colette A. Durkin, husband and wife, resided in Westchester, Illinois, at the time they filed their petitions. They filed their joint Federal income tax returns for 1977, 1978, 1979, and 1980 with the Internal Revenue Service Center at Kansas City, Missouri. The petitioners, Jerome A. and Sybil G. Grossman, husband and wife, resided in Northbrook, Illinois, at the time they filed their petitions. They filed their joint Federal income tax returns for 1978, 1979, and 1980 with the Office of the District Director of Internal Revenue, Chicago, Illinois.

During all the years at issue, Paramount Pictures Corp. (Paramount) was a subsidiary of Gulf & Western Co. (G & W), a diversified holding company. During such years, Paramount was an industry leader engaged in the production, acquisition, and distribution of feature motion pictures, and in the production and distribution of television movies and series. Paramount's production facilities were located in Los Angeles, and its distribution activities were coordinated in New York. It also had approximately 40 branch offices throughout the country involved in motion picture distribution. It made substantially greater profit from distribution than it did from production. It sought to supply its large distribution network with between 15 and 20 motion pictures per year.

Since 1968, Charles J. Arney, Jr., has held various positions at Paramount and its parent company, G & W. In 1972, he was the assistant controller at Paramount. In 1975 and 1976, he took the position of director of treasury operations. In November 1977, he became the president of Gulf & Western-Canada, Ltd. In January 1979, he went to the west coast as the tax department representative at Paramount. In October 1979, he started working for Arthur Barron, the executive vice president of finance and administration for Paramount. Mr. Arney was the principal negotiator for Paramount in the transactions at issue in this case.

Calvin Eisenberg is an attorney who worked for the Internal Revenue Service for approximately 4 years. In 1966, he joined the law firm of Levenfeld & Kanter (the law firm),[2] where he has worked ever since. Prior to 1977, he was involved in establishing several motion picture "service company" partnerships. Such a partnership was responsible for all aspects of bringing a motion picture into existence for a fixed price. Paramount was a partner in several of such partnerships.

John Heyman has been involved in the entertainment industry for many years. Upon graduation from Oxford University Graduate School, he began working in the commercial television industry creating, writing, and packaging shows. Packaging a show consists of organizing all the nontechnical aspects of the show, such as the script, the director, and the cast. Later, he became a theatrical agent representing, among others, Elizabeth Taylor, Richard Burton, Richard Harris, Lawrence Harvey, Trevor Howard, and Burt Bacharach. As an agent of highly sought after entertainers, his primary duties were to identify the best jobs and to negotiate the contracts for such jobs. He negotiated his first "negative pick-up" deal with Paramount in 1971 or 1972. Such a deal involves the purchase of the negative of a motion picture after it has been completed; the purchaser picks up the film as a finished product. The purchase can be contracted for at anytime, including before production starts. He successfully negotiated six or seven such deals in 1977, a similar number in 1978, and eight or nine in 1979.

World Film Services, Ltd. (WFS), is a British concern which was formed by Mr. Heyman in the early 1960s. Since the inception of WFS, he has owned all but 1 share of its stock and has served as a director. The remaining share is held by a nominee, as required by British law. During the mid-1970s, WFS usually had between 6 and 20 full-time employees in the London office. During the production of a film, WFS had as many as 300 employees.

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[2] The law firm has changed name and membership several times since 1966. Currently, the law firm of Levenfeld, Eisenberg, Janger, Glassberg & Samotny is a successor.

In 1973, the Film Writers Co. (FWC),[3] a California corporation, was formed as a subsidiary of WFS through the merger of the West Coast Film Writers Co. and the East Coast Film Writers Co. Such corporation was a signatory to the Writers Guild of America basic agreement, the Producers-Writers Guild of America Pension Plan, and the Motion Picture Health and Welfare Fund. It has been involved in several ventures in the entertainment industry. The corporation had no more than 6 employees when not in production, and up to 200 when in production.

During the years at issue, Bernard M. Filler was the chief operating officer and principal shareholder of Capital B Corp. (Capital B). Prior to graduating from Stanford Law School in 1962, he attended the University of Illinois and passed the Certified Public Accountant's exam. Mr. Filler served on the board of editors of the Stanford Law Review and is a member of The Order of the Coif. For 7 years, while in New York, he practiced law in the areas of corporate securities, investment banking, and finance while an associate at Paul, Weiss, Rifkind, Wharton & Garrison. In 1974, he became partner in charge of corporate development at the Chicago law firm of Holleb, Gerstein & Glass (the Glass firm).

In 1977, Mr. Filler decided to abandon the practice of law and to form an investment banking firm, Capital B. The initial share distribution of Capital B was 40 percent to Mr. Filler, 50 percent to members of the law firm, or trusts or partnerships associated with them, and 10 percent to members of the Glass firm. For the years 1977 through 1980, Mr. Filler was the president of Capital B. At various times during such years, Roger Baskes, Mr. Eisenberg, Steven Felsenthal, Stanford L. Glass, and Milton Levenfeld were the other officers of Capital B. Messrs. Baskes, Eisenberg, Filler, Glass, Kanter, and Levenfeld, together with Robert Gerstein, Michael Friedberg, and Richard K

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[3] FWC has changed its State of incorporation several times during its existence. Where aid, the State if incorporation will be indicated, e.g., FWC-Cal.; where not relevant, the State of incorporation will not be indicated.

Janger served as directors of Capital B during such years; Messrs. Filler, Glass, and Kanter served in such capacity every year. Messrs. Baskes, Eisenberg, Friedberg, Janger, Kanter, and Levenfeld were partners in the law firm, Mr. Felsenthal was an associate of the law firm, and Messrs. Gerstein and Glass were partners in the Glass firm.

During the first months of 1977, Capital B actively sought to participate in a number of bona fide investment banking projects. Because Mr. Filler believed that the presence of partners of the law firm and the Glass firm gave potential customers the impression that Capital B had the resources to meet their needs, he frequently asked such partners to participate in meetings with potential customers. In May 1977, Capital B received its first fee, in the amount of $6,000, from the syndication of an oil and gas partnership. Mr. Filler wrote memorandums concerning his activities. Such memorandums were distributed to the Capital B board of directors.

From 1977 through 1980, Capital B served as a general partner in at least 10 motion picture negative pickup partnerships organized with the assistance of the law firm. For each such year, at least 85 percent of Capital B's gross receipts were guaranteed payments from such partnerships. Starting on January 1, 1978, Capital B paid the law firm a monthly retainer of $75,000; a few months later, such retainer was increased to $100,000 per month.

Prior to the establishment of Capital B, Mr. Eisenberg determined that motion picture service company transactions were not very profitable and were difficult to structure and manage. Additionally, section 280, added to the Code by section 210 of the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1544, required individuals to capitalize the cost of producing films and to amortize such cost essentially in conformity with the income-forecast method. Such requirement decreased the profitability of motion picture service company partnerships which had previously been allowed to deduct the full costs of production as they were incurred. As a result, Mr. Eisenberg has not been involved in forming any such partnerships since the time of the 1976 act.

In 1977 and 1978, all of the motion pictures purchased by Mr. Heyman through FWC were sold to partnerships organized by Capital B and Mr. Eisenberg. In 1979, FWC again sold films to such partnerships, and FWC sold $108 million or $109 million worth of films to a British bank. In 1980, FWC effectively stopped doing business in the United States. Such stoppage resulted from the breakup of the law firm and resultant divided loyalties on the part of Mr. Heyman. At the same time, Mr. Heyman did a great deal of business in England.

In 1980, on the advice of its accountant, FWC transferred certain of its assets and liabilities to a wholly owned subsidiary, FWC-Del. Such transfer was made to avoid certain New York State income taxes. FWC-Del. opened an office in Chicago in the same building as the offices of the law firm. Lester Bernstein, president of FWC-Del., accepted the assignment from FWC of certain motion picture acquisition agreements and purchase agreements, including those concerning the transactions at issue. Notification of such assignments was sent to Paramount by FWC. Such notification was prepared by the law firm and signed by Pamela H. Osowski. Paramount acknowledged receipt of such notification in a letter to the law firm. At such time, Mr. Bernstein was involved in other activities concerning the law firm.

In March or April of 1977, Mr. Heyman contacted Mr. Eisenberg and asked if he would be interested in purchasing two motion pictures which FWC was in the process of obtaining. Such films were "The Bad News Bears in Breaking Training" ("Bears 2"), a Paramount picture, and "Greased Lightning," a Warner Brothers picture. Although Mr. Filler was apprehensive about the enterprise, it was decided that Capital B would form a limited partnership to purchase such films.[4] At that time, it was agreed that Mr. Eisenberg, who had known Mr. Filler since 1974 or 1975, would provide the expertise for negotiations and other activities where his knowledge of the film industry would be helpful, and that Mr. Filler would handle the administrative details of such partnership. Shortly thereafter, Capital B formed Ambassador Associates (Ambassador), a limited partnership. Such partnership, like those involved in the case at hand, was intended to engage in negative pickup transactions.

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[4] Use of such terms as "acquisition," "purchase," "assign," "sale," "own," "interest," "principal," and "price" should not be construed as carrying any conclusion as to the legal effect of the documents or transactions involved herein.

On July 27, 1977, FWC purchased "Bears 2." Due to the lack of subscriptions, such motion picture was the only one purchased by Ambassador. On the same day, FWC entered into a letter agreement with Paramount under which the parties agreed to the sale and distribution of six other motion pictures under terms substantially the same as those in the acquisition agreement and the distribution agreement pertaining to "Bears 2." The motion pictures included in such letter agreement were: "Saturday Night Fever," "Duellists," "Heaven Can Wait," "Looking For Mr. Goodbar," "First Love," and "The One and Only." Such letter agreement set forth the closing and release dates, and the acquisition agreement and distribution agreement terms for each motion picture. Although not legally committed to do so, in July 1977, limited partnerships formed by Capital B purchased all six pictures.

The acquisition agreement, dated November 2, 1977, by which Paramount sold "First Love" to FWC provided, in pertinent part:

> 1. SELLER'S REPRESENTATIONS AND WARRANTIES: The SELLER represents and warrants that as of the date hereof:
>
> * * * * * * *
>
> 1.8 SELLER has obtained customary Errors and Omissions Insurance from Fireman's Fund pursuant to SELLER's blanket policies, such coverage to be for the benefit of SELLER and PURCHASER as their interest may appear. * * *
>
> * * * * * * *
>
> 1.14 Except for the purchase price payable hereunder, and the gross receipts participations and deferments listed in Exhibit "A" annexed hereto, and customary musical performance rights payments and "residual" payments pursuant to applicable collective bargaining agreements, no sums are or will be due or payable by the PURCHASER with respect to the PICTURE or by anyone authorized by the PURCHASER to exercise any of the rights, powers, licensese [sic] and privileges herein granted to the PURCHASER. This warranty shall not be applicable to any sums due or payable by reason of any transactions entered into by PURCHASER with respect to the PICTURE, except insofar as such transaction shall cause any sums to become due and/or payable pursuant

to an agreement and/or commitment made by SELLER or by which SELLER is bound.

1.15 * * * The SELLER is the copyright proprietor of the PICTURE. * * *

1.16 The PICTURE was produced in the United States of America.

* * * * * * *

1.18 The SELLER has obtained all the necessary documentation authorizing the production, exhibition, performance, distribution, marketing and exploitation of the PICTURE and the rights sold hereunder, throughout the world, for any and all purposes, and by every means, method and device now or hereafter known and required for the full, complete and unlimited exercise and enjoyment by the PURCHASER, its grantees and licensees, of each and all of the distribution, exhibition, broadcast and exploitation rights sold to the PURCHASER, and the PURCHASER shall own, possess and enjoy all such rights without any liability or obligation to or hindrance by any person, firm or corporation, except as otherwise specified herein.

* * * * * * *

3. SALE: SELLER hereby sells to PURCHASER and PURCHASER hereby purchases from SELLER all of SELLER'S rights, title and interest of any and every kind and character whatsoever in and to the PICTURE, the copyright therein (and all renewals and extensions thereof), and the original negative thereof. Without limiting the generality of the foregoing, SELLER hereby sells, transfers and assigns to PURCHASER all of those items specified in Exhibit "B" attached hereto, all rights, title and interest in and to the PICTURE and any and all parts thereof and the literary, musical and dramatic material contained therein (but only as embodied therein) throughout the world, and the sole, exclusive and irrevocable right, license and privilege, under copyright and otherwise, to distribute, sub-distribute, reproduce[,] exhibit, project, license, perform, sell, market, broadcast, issue, reissue, and advertise, publicize, dispose of, turn to account, derive revenue from and otherwise exploit and deal in and with the PICTURE and any and [all] parts thereof throughout the world, in any and all media, methods, system and process, whether now known or hereafter devised and in all gauges film and other surfaces, whether in movie theatres, on armed forces bases[,] on ships, on aircraft, on radio, on television (including without limitation, free, cable, subscription and pay), through cassettes, cartridges, tapes and other audio or video devices, CATV and any other method or means for the exhibition, performance or exploitation of the PICTURE theatrically[,] non-theatrically, and/or by means of television in any and all gauges, forms, procedures or processes or in any other fashion or through any other medium whatsoever, whether now known or hereafter devised and in all languages. The literary and dramatic material included in the PICTURE shall be deemed sold to PURCHASER only to the extent included in the PICTURE. The music rights sold shall be subject to the conditions contained in the licenses relating thereto.

4. TERRITORY AND TERM: The Territory covered by this Agreement shall consist of the entire world. The term hereof shall be in perpetuity.

5. DELIVERY:

5.1 The SELLER shall deliver the PICTURE to PURCHASER promptly upon execution hereof by making physical delivery to MGM Laboratory Inc. at 10202 West Washington Boulevard, Culver City, California 90030 (herein the LABORATORY), in the PURCHASER'S name but at the SELLER'S sole cost and expense, of each and all of the film and sound material specified in Exhibit "C" attached hereto and made a part hereof. SELLER shall also cause to be delivered to PURCHASER, at SELLER's expense, a laboratory letter from said LABORATORY, in form and substance like that attached hereto as Exhibit "C", certifying that said LABORATORY holds said materials to the PURCHASER'S account and for the PURCHASER'S sole benefit, and certifying further that the negative of the PICTURE and the other items so delivered are of a grade and quality satisfactory for the reproduction of commercially acceptable 35mm release prints of the PICTURE with synchronized English language dialogue and sound track.

5.2 The pre-printed material pertaining to the PICTURE shall be kept at the LABORATORY in the name of PURCHASER or its designee or the distributor whom PURCHASER or its designee licenses to distribute the PICTURE, PURCHASER being hereby authorized to transfer said materials to the account of said distributor and/or designee, but in all events subject to the provisions of the Security Agreement referred to hereinafter.

5.3 SELLER shall also deliver to PURCHASER in addition to the materials specified on Exhibit "B":

a) A verified statement showing the Negative Cost[5] of the PICTURE, including overheads to SELLER of 25% of the direct costs of production and interest, to be not less than $2,496,000.

* * * * * * *

6. DISTRIBUTION AND CONTROL OF PICTURE:

6.1 Subject to the provisions of this Agreement, and all exhibits attached hereto, the PURCHASER shall, at all times, have full control in its absolute discretion over the manner and terms upon which the PICTURE shall be marketed, distributed, exploited, exhibited, sold, licensed or otherwise disposed of, and all matters pertaining thereto. So long as the arrangements for the distribution of the PICTURE are made through a "major" distributor (as that term is understood in the motion picture industry), PURCHASER shall have the right to delegate the authority granted herein to such distributor.

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[5] The negative cost of a picture is the total direct cost involved in the manufacture of the film, including "below-the-line" elements, such as, producers' fees, directors' fees, actors' fees, script costs, the costs associated with the acquisition of underlying rights, technicians' fees, laboratory costs, film cost, and the cost of building sets.

7. PURCHASE PRICE

The purchase price for all rights and property sold, transferred and assigned by SELLER to PURCHASER hereunder shall be the sum of $2,496,000.00, payable as follows:

a) The sum of $116,000, payable $15,000 contemporaneously herewith by delivery to SELLER of a bank check in said amount, subject to collection, receipt whereof is hereby acknowledged and $101,000 on December 1, 1977.

b) The sum of $208,000 payable by delivery to SELLER upon execution hereof of PURCHASER'S non-interest bearing promissory note in the amount of $208,000 payable to the order of SELLER, which note shall have a maturity date of June 30, 1978, and which shall be a recourse note in the form like that set forth in Exhibit "D" attached hereto.

c) The sum of $2,172,000 payable by delivery to SELLER upon execution hereof of PURCHASER'S promissory note in the amount of $2,172,000 payable to the order of SELLER, which note shall have a maturity date of June 30, 1986, with interest on the unpaid balance at the rate of 8% per annum, which note shall be in form like that set forth in Exhibit "E" annexed hereto and which note shall be a non-recourse note, i.e. SELLER'S rights to payment thereof shall be limited solely to payment thereof out of the percentage payments if any, derived by PURCHASER from the distribution of the PICTURE.

* * * * * * *

10. COLLATERAL SECURITY:

10.1 As collateral for payment of the promissory notes to be executed by the PURCHASER hereunder, the PURCHASER shall execute and deliver to SELLER a security agreement * * * granting SELLER the first and prior security interest and lien upon all the right, title and interest of the PURCHASER in and to the PICTURE, * * * and all other property and rights acquired by PURCHASER hereunder. * * *

* * * * * * *

2. INDEMNITY: SELLER agrees to defend, indemnify and hold harmless the PURCHASER, * * * its * * * successors and assigns, * * * from and against any charges, damages, costs and expenses, * * * which may be sustained or suffered by or secured against them or any of them by reason of, based upon or relating to, a breach of any of the SELLER'S covenants, representations, warranties or agreements contained herein, or in the exercise or attempted exercise of any of the rights, licenses or privileges herein granted * * *

Such agreement was signed by P.B. Powell for Paramount and Ms. Osowski for FWC. The acquisition agreements for all the other films were signed by Walter Joseph, Jr., for Paramount and Ms. Osowski for FWC.

The acquisition agreements for the other films were nearly identical to the "First Love" acquisition agreement.

The acquisition agreements for "The One and Only" and "Heaven Can Wait" were dated December 2, 1977. The total purchase price of "The One and Only" was $4,770,000: $5,000 payable contemporaneously with execution of the acquisition agreement, $207,000 payable on December 20, 1977, a recourse promissory note for $53,500 with a maturity date of June 30, 1978, a similar note for $477,000 payable on June 30, 1979, and a nonrecourse interest-bearing promissory note for $4,027,500 with a maturity date of June 30, 1986.[6] The total purchase price of "Heaven Can Wait" was $12,534,500: $10,000 payable contemporaneously with execution of the acquisition agreement, a recourse promissory note for $914,000 with a maturity date of June 30, 1978, a similar note for $1,384,625 payable on June 30, 1979, and a nonrecourse interest bearing note for $10,225,875 with a maturity date of June 30, 1986.

The acquisition agreements for "Grease," "Foul Play," and "Bad News Bears Go to Japan" ("Bears 3") were dated May 25, 1978. The total purchase price of "Grease" was $8,179,600: $25,000 payable contemporaneously with execution of the acquisition agreement, a recourse promissory note for $1,201,940 with a maturity date of June 30, 1978, a similar note for $817,960 payable on June 30, 1979, and a nonrecourse interest-bearing promissory note for $6,134,700 with a maturity date of June 30, 1986. The total purchase price of "Foul Play" was $6,695,000: $25,000 payable contemporaneously with execution of the acquisition agreement, a recourse promissory note for $979,250 with a maturity date of June 30, 1978, a similar note for $669,500 payable on June 30, 1979, and a nonrecourse interest-bearing promissory note for $5,021,250 with a maturity date of June 30, 1986. The total purchase price of "Bears 3" was $5,682,300: $25,000 payable contemporaneously with execution of the acquisition agreement, a recourse promissory note for $827,345 with a maturity date of June 30, 1978, a similar note for $568,230 payable on June 30, 1979, and a nonrecourse interest bearing promissory note for $4,261,725 with a maturity date of June 30, 1986.

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[6] Use of terms such as "recourse" and "nonrecourse" in connection with promissory notes should not be construed as carrying any conclusion as to the legal effect of the documents or transactions involved.

Balmoral Associates, Ltd. (Balmoral), is an Illinois limited partnership of which Capital B and Mr. Filler are the general partners. Balmoral purchased "First Love" and "The One and Only" from FWC. The private placement memorandum describes "First Love" as:

> a bittersweet, tender love story set on a contemporary college campus and told from a woman's point of view. A young man of a decidedly romantic temperament meets the girl of his dreams, but she turns out to be far more worldly than he anticipates. Played out on campus and in the girl's lavish family mansion, the couple's ensuing love affair eventually dissolves as a result of her persistent attraction to an older, married man.
>
> This motion picture, based upon a short story by Harold Brodkey, was produced by Larry Turman ("The Graduate", "The Great White Hope", "The Best Man" and "The Flim Flam Man") and directed by Joan Darling. "First Love" stars Susan Dey (star of the successful television series "Partridge Family") and William Katt ("Carrie"). * * *

"The One and Only" is described in such memorandum as:

> a funny and tender story which gives the audience a glimpse into the life and romance of Gorgeous George as a young man. This motion picture climaxes when George dons a fur-trimmed gold robe and blond wig with a hairnet and enters the Madison Square Garden wrestling arena to thunderous applause.
>
> This motion picture was produced and written by Steve Gordon and directed by Carl Reiner ("Oh, God!" and "Where's Poppa?"). * * * [It] stars Henry Winkler, television's "Fonzie". * * *

For convenience, "First Love" and "The One and Only" will sometimes be referred to as "Balmoral's motion pictures" or "the Balmoral motion pictures."

Shelburne Associates, Ltd. (Shelburne), is an Illinois limited partnership of which Capital B and Mr. Filler are the general partners. The private placement memorandum contained the following descriptions of the four motion pictures purchased by Shelburne from FWC:

> (a) "*Grease*".
>
> "Grease", the film version of the longrunning show, is a musical celebration of rock and roll in the Fifties with a cast including John Travolta ("Saturday Night Fever"), Olivia Newton-John and Stockard Channing.
>
> This motion picture was produced by Robert Stigwood Organization and was directed by Allen Carr. * * *

> (b) *"Heaven Can Wait"*.
>
> "Heaven Can Wait", a remake of the 1949 original film starring Gene Tierney and Don Ameche, is a comedy fantasy about a famous football player who dies before his time and is given the ultimate comeback, a chance to return to Earth.
>
> This motion picture was produced by Warren Beatty ("Shampoo" and "Bonnie and Clyde") and directed by Warren Beatty and Buck Henry, with screenplay by Elaine May. "Heaven Can Wait" stars Warren Beatty, Julie Christie, James Mason and several other prominent artists. * * *
>
> (c) *"Bad News Bears Go To Japan"*.
>
> Following the two preceding popular Bad News Bears pictures, "Bad News Bears Go To Japan" picks up the team of sandlot youngsters on their way from Los Angeles to the Orient, raising havoc with the American pastime.
>
> This motion picture was produced by Michael Ritchie, directed by John Berry and stars Tony Curtis with the Bad News Bears team. * * *
>
> (d) *"Foul Play"*.
>
> From the creator of "Silver Streak" and "Harold and Maude", "Foul Play" is a comic thriller that brings together on the screen the wacky charms of Goldie Hawn and Chevy Chase.
>
> This motion picture was produced by Thomas L. Miller and Edward K. Milkis and directed by Colin Higgins. * * *

For convenience, "Grease," "Heaven Can Wait," "Bears 3," and "Foul Play" will sometimes be referred to as "Shelburne's motion pictures" or "the Shelburne motion pictures."

The purchase agreements by which the partnerships acquired the films from FWC were signed by Mr. Filler as the representative of the relevant partnership. Each of the purchase agreements was nearly identical to the corresponding agreement by which FWC acquired the film. The only relevant differences were that the purchase agreements did not mention the purchase of errors and omissions insurance and that the financial terms differed. The consideration paid by Balmoral for "First Love" was $2,571,000: $10,000 payable upon execution of the purchase agreement, $130,000 payable on December 1, 1977, $259,000 payable on or before June 30, 1978, and a recourse 8-percent interest-bearing promissory note for $2,172,000 with a maturity date of June 30, 1986. The purchase agreement provided that such:

> note shall become and be without recourse to the extent of fifty percent (50%) of the original principal amount thereof when the distributor's

> gross receipts (as defined in the distribution agreement relating to PICTURE to be entered into by PURCHASER and when said distributor accounts to PURCHASER therefore) from the distribution in the United States equals ONE MILLION FIVE HUNDRED THOUSAND ($1,500,000) and said distributor's gross receipts from all other territories equals ONE MILLION FIVE HUNDRED THOUSAND DOLLARS ($1,500,000), and shall become and be without recourse as to the full extent thereof when said distributor's worldwide gross receipts equals FIVE MILLION DOLLARS ($5,000,000). In all events the entire note shall become nonrecourse to the full extent thereof upon a licensing of the syndicated television exhibition rights of the PICTURE and receipt by the said distributor of the sum due to it upon the first syndicated television broadcast of the PICTURE.

The consideration paid by Balmoral for "The One and Only" was $4,870,000: $212,000 payable on or before December 20, 1977, $403,500 payable on or before June 30, 1978, $227,000 payable on or before June 30, 1979, and a recourse 8-percent interest-bearing promissory note for $4,027,500 with a maturity date of June 30, 1986. The purchase agreement provided that such:

> note shall become and be without recourse to the extent of fifty percent (50%) of the original principal amount thereof when the distributor's gross receipts (as defined in the distribution agreement relating to PICTURE to be entered into by PURCHASER and when said distributor accounts to PURCHASER therefore) from the distribution in the United States equals THREE MILLION FIVE HUNDRED THOUSAND DOLLARS ($3,500,000) and said distributor's gross receipts from all other territories equals THREE MILLION FIVE HUNDRED THOUSAND ($3,500,000), and shall become and be without recourse as to the full extent thereof when said distributor's worldwide gross receipts equals ELEVEN MILLION DOLLARS ($11,000,000). In all events the entire note shall become nonrecourse to the full extent thereof upon a licensing of the syndicated television exhibition rights of the PICTURE and receipt by the said distributor of the sum due to it upon the first syndicated television broadcast of the PICTURE.

The consideration paid by Shelburne for "Heaven Can Wait" was $12,734,500: $10,000 payable on or before December 20, 1977, $1,014,000 payable on or before June 30, 1978, $1,484,625 payable on or before June 30, 1979, and a recourse 8-percent interest-bearing promissory note for $10,225,875 with a maturity date of June 30, 1986. The purchase agreement provided that such:

> note shall become and be without recourse to the extent of fifty percent (50%) of the original principal amount thereof when the distributor's gross receipts (as defined in the distribution agreement relating to PICTURE to be entered into by PURCHASER and when said distributor accounts to PURCHASER therefore) from the distribution in the United States equals TEN MILLION DOLLARS ($10,000,000) and said distributor's gross receipts from all other territories equals SEVEN MILLION FIVE HUNDRED THOUSAND DOLLARS ($7,500,000), and shall become and be without recourse as to the full extent thereof when said distributor's worldwide gross receipts equals TWENTY FIVE MILLION DOLLARS ($25,000,000). In all events the entire note shall become nonrecourse to the full extent thereof upon receipt by the said distributor of more than $1,500,000 from the television exhibition of the PICTURE and the exhibition of the PICTURE on free home television.

The consideration paid by Shelburne for "Grease" was $8,429,600: $25,000 payable upon execution of the purchase agreement, $1,352,000 payable on or before June 30, 1978, $917,900 payable on or before June 30, 1979, and a recourse 8-percent interest-bearing promissory note for $6,134,700 with a maturity date of June 30, 1986. The purchase agreement provided that such:

> note shall become and be without recourse to the extent of fifty percent (50%) of the original principal amount thereof when the distributor's gross receipts (as defined in the distribution agreement relating to PICTURE to be entered into by PURCHASER and when said distributor accounts to PURCHASER therefore) from the distribution in the United States equals ELEVEN MILLION DOLLARS ($11,000,000) and said distributor's gross receipts from all other territories equals FOUR MILLION DOLLARS ($4,000,000), and shall become and be without recourse as to the full extent thereof when said distributor's gross receipts from the United States equals SIXTEEN MILLION DOLLARS ($16,000,000) and said distributor's gross receipts from all other territories equals FOUR MILLION DOLLARS ($4,000,000). In all events the entire note shall become nonrecourse to the full extent thereof when said distributor's gross receipts from other than theatrical sources equal or exceed SIX MILLION FIVE HUNDRED THOUSAND DOLLARS ($6,500,000).

The consideration paid by Shelburne for "Foul Play" was $6,845,000: $25,000 payable upon execution of the purchase agreement, $1,079,250 payable on or before June 30, 1978, $719,500 payable on or before June 30, 1979, and a recourse 8-percent interest-bearing promissory note for $5,021,250 with a maturity date of June 30, 1986. The purchase agreement provided that such:

> note shall become and be without recourse to the extent of fifty percent (50%) of the original principal amount thereof when the distributor's gross receipts (as defined in the distribution agreement relating to PICTURE to be entered into by PURCHASER and when said distributor accounts to PURCHASER therefore) from the distribution in the United States equals NINE MILLION DOLLARS ($9,000,000) and said distributor's gross receipts from all other territories equals TWO MILLION FIVE HUNDRED THOUSAND DOLLARS ($2,500,000), and shall become and be without recourse as to the full extent thereof when said distributor's gross receipts from the United States equals TWELVE MILLION DOLLARS ($12,000,000) and said distributor's gross receipts from all other territories equals THREE MILLION DOLLARS ($3,000,000). In all events the entire note shall become nonrecourse to the full extent thereof when said distributor's gross receipts from other than theatrical sources equal or exceed FOUR MILLION DOLLARS ($4,000,000).

The consideration paid by Shelburne for "Bears 3" was $5,782,300: $25,000 payable upon execution of the purchase agreement, $887,345 payable on or before June 30, 1978, $608,230 payable on or before June 30, 1979, and a recourse 8-percent interest-bearing promissory note for $4,261,725 with a maturity date of June 30, 1986. The purchase agreement provided that such:

> note shall become and be without recourse to the extent of fifty percent (50%) of the original principal amount thereof when the distributor's gross receipts (as defined in the distribution agreement relating to PICTURE to be entered into by PURCHASER and when said distributo accounts to PURCHASER therefore) from the distribution in the United States equals SEVEN MILLION FIVE HUNDRED THOUSAND DOL LARS ($7,500,000) and said distributor's gross receipts from all other territories equals TWO MILLION FIVE HUNDRED THOUSAND DOLLARS ($2,500,000), and shall become and be without recourse as to the full extent thereof when said distributor's gross receipts from the United States equals TEN MILLION DOLLARS ($10,000,000) and said distributor's gross receipts from all other territories equals TWO MILLION FIVE HUNDRED THOUSAND DOLLARS ($2,500,000). In all events the entire note shall become nonrecourse to the full extent thereof when said distributor's gross receipts from other than theatrical sources equal or exceed SIX MILLION DOLLARS ($6,000,000).

Promissory notes and other obligations due before 198 will sometimes be referred to as short-term notes and wil sometimes be identified by payor. Promissory notes due i 1986 will sometimes be referred to as long-term notes an will sometimes be identified as recourse or nonrecourse and by payor.

The purchase agreements for all the motion pictures had a guaranty paragraph. For "First Love" and "The One and Only," Balmoral had to "secure guarantees of 50% of the principal amount of PURCHASER'S note to SELLER on a prorata basis from each of its limited partners." For "Grease," "Foul Play," and "Bears 3," Shelburne had to secure the guarantee of 97 percent of such principal amount, and for "Heaven Can Wait," 100 percent had to be guaranteed.

The security agreements executed between FWC and the partnerships incorporated the following clause:

> 12A. *Distribution Agreement.* The Secured Party acknowledges that Debtor shall be granting certain rights and licenses with respect to the Photoplay pursuant to a distribution agreement including, without limitation, certain distribution rights and fees and the right to recoup certain advances, and that the security interest granted hereby shall be in all respects subordinate and junior to the rights granted in said distribution agreement. Nothing contained herein and no action taken by the Secured Party hereunder shall affect or diminish such rights of the distributor under said distribution agreement.

The distribution agreement, dated November 2, 1977, by which Balmoral granted certain rights in "First Love" to Paramount, provided in pertinent part:

> 1. DISTRIBUTION RIGHTS AND PERIOD: Partnership does hereby irrevocably grant and license to Paramount its successors and assigns under copyright and all renewal or extended copyrights the exclusive right and privilege, during the term hereof, and for the Paramount Territory to distribute, exhibit, market, re-issue and otherwise exploit, and to license and permit others to distribute, exhibit, market, re-issue and otherwise exploit, the Picture and the literary, and dramatic material contained in the Picture (but only as embodied therein) and all other rights, properties and interests therein and thereto to the extent owned by Partnership * * * and to make any changes, eliminations or additions thereto, as Paramount may determine.
>
> All references herein to the "Paramount Territory" shall be deemed to refer to the entire world.
>
> The distribution rights herein granted to Paramount shall include, without limitation, the right to distribute or exploit the Picture by means of so-called free television and/or pay or subscription television, community antennae television systems, cassettes, cartridges, tape or electronic visual recording systems, and in any other method or means for the exhibition, performance or exploitation of the Picture theatrically, non-

theatrically in any and all gauges, forms and procedures and/or by means of television or any similar process or in any other fashion or through any other medium whatsoever whether now known or hereafter devised and in all languages. The music rights licensed hereunder shall be subject to the conditions contained in the licenses relating thereto.

The term of this Agreement is

(a) a period of twenty-eight (28) years commencing from the date hereof and,

(b) thereafter and in perpetuity for successive additional periods of twenty-eight (28) years,

provided, however, that in the event the proceeds payable to Partnership under subparagraph 3 FOURTH of this Agreement shall have attained the sum of $5 million prior to the commencement of any of the additional periods described in (b) hereof, Paramount agrees to pay Partnership upon the date of commencement of any said additional twenty-eight (28) year period, the sum of Five Thousand Dollars ($5,000) or the then fair-market value of the Picture, whichever is the greater, which sum shall constitute an advance against any further sums which thereafter may become due and payable to Partnership pursuant to subparagraph 3 FIFTH of this Agreement. Paramount's failure to make such payment shall not divest Paramount of its right to extend and to be deemed to have extended the term hereof for said additional period unless and until Partnership shall have given Paramount, by prior written notice * * * sixty (60) days within which to elect not to extend for said additional period and Paramount shall not have tendered payment to Partnership of said consideration on or before the expiration of the said sixty (60) day period. In the event the proceeds payable to Partnership under subparagraph 3 FOURTH of this agreement shall not have attained the sum of $5 million at the time of the commencement of any of the additional periods described in (b) hereof, Paramount shall have extended and shall be deemed to have extended said rights for said additional period and no consideration shall then be due and payable from Paramount to Partnership for the extension of said additional period; however, during any said additional period if and when the proceeds payable to Partnership under subparagraph 3 FOURTH of this Agreement shall have attained the sum of $5 million, then the aforesaid advance of $5,000 or the then fair-market value of the Picture, whichever is the greater, shall be due and payable in consideration of the extension of the term hereunder and for the remainder of the then additional period but Paramount shall not be in default for failure to pay same until and unless notice thereof shall have been given by Partnership in the manner aforestated.

* * * * * * *

2. * * *

(c) * * *

Paramount * * * may make outright territorial grants covering the distribution of the Picture in any part of the Paramount Territory without limitation, whether or not Paramount * * * shall there maintain its own exchanges, provided, however, that it shall not make any "outright sale" with respect to the theatrical distribution of the Picture in the United States or Canada. * * *

(e) Paramount agrees to cause the Picture to be released in the countries of the Paramount Territory as soon as reasonably practicable consistent with Paramount's policies regarding release in any such country, * * *

* * * * * *

3. THEATRICAL AND PAY TELEVISION DISTRIBUTION FEES: U.S.A. AND CANADA 30% UNITED KINGDOM 35% REST OF WORLD 40% TERRITORIAL GRANTS 10% FREE TELEVISION DISTRIBUTION FEES: U.S.A. NETWORK SALES 25% U.S.A. SYNDICATION AND CANADA 35% REST OF WORLD 40%

For all other gross receipts, distribution fees will be the same as theatrical for the applicable territory.

The gross receipts (as defined in Paragraph 2 hereof) shall be apportioned in the following order:

FIRST: (a) Partnership shall receive a sum equal to one and three-quarter (1¾%) percent of gross receipts until such time as the Partnership shall have been paid pursuant to subparagraph FOURTH below an amount equal to the sum of $2,496,000, plus interest thereon at the rate of 8% per annum commencing on the date hereof when, Partnership thereafter shall receive a sum equal to three (3%) percent of gross receipts derived thereafter. * * * [Union and guild costs are to be deducted prior to computing sums payable to the Partnership.]

(b) Paramount shall retain a sum equal to gross receipts multiplied by appropriate distribution fees as set forth above.

SECOND: Thereafter, Paramount shall recoup and reimburse itself for a sum equal to all of its distribution advances paid or incurred by Paramount * * *

THIRD: Thereafter, there shall be deducted from gross receipts the total of all sums due and owing to such persons, firms and/or corporations other than Partnership and Paramount to whom deferred compensation and/or participations in gross receipts by way of deferred compensation or otherwise are owing by reason of contractual commitments to them in connection with the acquisition of rights and rendition of services for the Picture. * * *

FOURTH: Thereafter, 100% of remaining gross receipts shall be paid to Partnership until Partnership has been paid the sum of $2,848,941, together with interest thereon at the rate of 8% per annum commencing on the date hereof.

FIFTH: Thereafter, any gross receipts remaining shall be apportioned as follows: Partnership—sums equal to 15% thereof, Paramount—sums equal to 85% thereof. In the event either Paramount or Partnership gives up or assigns to any third party a share of any amounts payable hereunder, such share shall be payable wholly out of said respective party's share if and when such share becomes available in accordance with the terms of this Agreement.

* * * * * * *

4. On or before December 1, 1977, Partnership will pay Paramount $300,000, which sum will be used to pay the advertising costs hereunder, which costs shall be deemed paid by Partnership. Promptly after said sum has been expended Paramount shall provide Partnership with a statement showing the manner in which said sum was so expended.

* * * * * * *

6. * * *

(h) * * * Paramount has obtained customary Errors and Omissions Insurance with Firemans Fund pursuant to Paramount's blanket policies, such coverage to be for the benefit of Paramount and Partnership as their interests may appear. * * *

* * * * * * *

7. (a) Partnership agrees to defend, indemnify and hold harmless Paramount, its assignees and licensees, against any charges, damages, costs, and expense, * * * whatsoever, which may be sustained or suffered by or secured against them by reason of, or based upon or relating to a breach of any of Partnership's representations, warranties or agreements contained herein or in the exercise or attempted exercise of any of the rights, licenses or privileges herein granted * * *

8. Contemporaneously herewith, Partnership shall deliver the Picture to Paramount by delivering the items specified * * * to such laboratory as Paramount may designate. Such laboratory shall have the sole and exclusive right to possession and custody of the material to be delivered hereunder * * * during the entire period of Paramount's exclusive distribution hereunder. Partnership shall furnish Paramount with a Letter of Irrevocable Authority in Paramount's customary form of Laboratory Agreement to the laboratory Paramount designates so that Paramount and/or its subsidiary or affiliates shall be the only ones exclusively entitled to order prints or deal with any of the materials deposited therein with respect to the Picture. Paramount shall pay all storage costs and all costs for material ordered by it and shall hold Partnership harmless with respect thereto. Notwithstanding the above, Partnership will have access to the material deposited therein for the sole purpose o inspecting said material. Partnership shall not remove any of saic material from the laboratory.

9. (a) As between Partnership and Paramount, Paramount shall hav the right to determine the title under which the Picture shall b released * * *

(b) Partnership shall have the right to advise and consult witl Paramount with respect to the opening advertising and publicity campaign and the initial theatrical release of the Picture in the Unite States and Canada, and Paramount agrees to give good faith consider ation to Partnership's suggestions and advice, but Paramount['s] decisio in such matters shall be final.

(c) * * * Paramount shall have the right * * * to use and license th use of all material upon which the Picture was based or from which i was adapted, * * * subject, however, to the agreements between th producer of the Picture and such artists, authors and others appearing in or connected with the Picture.

* * * * * * *

11. If any person, firm or corporation shall do or perform any acts which Paramount believes constitute a copyright infringement of the Picture or of any * * * material contained in the Picture, * * * or violate or infringe any right of Partnership or Paramount therein or if any person, * * * shall do or perform any acts which Paramount believes constitute an unauthorized or unlawful distribution, exhibition, or use thereof, then and in any such event, Paramount may and shall have the right to take such steps and institute such suits or proceedings as Paramount may deem advisable or necessary to prevent such acts and conduct and to secure damages and other relief by reason thereof, * * * . Paramount may take such steps or institute such suits or proceedings in its own name or in the name of Partnership or in the names of the parties jointly, and Paramount is hereby appointed and constituted the lawful attorney-in-fact of Partnership to do all acts and things permitted or contemplated by the terms of this paragraph. * * *

* * * * * * *

13. All the rights in the Picture (including the copyright therein and negative thereof) excluding the rights herein granted to Paramount, are reserved to Partnership.

14. (a) Partnership hereby grants to Paramount for the term hereof, * * * the exclusive worldwide perpetual publication, performing, recording (including without limitation "original soundtrack album"), synchronization and all other rights in all musical compositions written for or used in or in connection with the Picture. Paramount may license any and all of such rights * * * to any other music publishing company of its choice * * * .

(b) * * * If Paramount grants record rights to any record company, Paramount shall endeavor to obtain the best available royalties in good faith negotiation with such record company, and in any event shall obtain not less than the following royalties:

* * * * * * *

15. * * * Paramount shall have, during the term hereof, the sole and exclusive merchandising rights in all stories, characters and objects, things and incidents described or appearing in the Picture, * * * . Without limiting the foregoing, merchandising rights shall include publication rights in novelizations of the screenplay and other publication rights to the extent acquired.

16. (a) Partnership agrees to accept Paramount's usual and normal methods of accounting, which Paramount agrees will be in accordance with generally accepted accounting principals [sic] and practices in the motion picture industry. Partnership shall have the right to inspect and audit in New York, Paramount's home office distribution records relating to the Picture, customarily maintained in New York, but not more frequently than once in any year, nor for any period previously audited or

more than two (2) years prior to the date of any such audit. Any such audit must * * * be completed within thirty (30) days after Paramount shall have made said distribution records available to Partnership or its representative. * * * Partnership agrees to accept, and Paramount agrees to provide statements quarterly for the first two (2) years following general release of the Picture, semi-annually for the third year, and annually thereafter so long as the Picture is in active distribution. Such statements shall be provided within 90 days of the close of the accounting period in question. Such statements may be on a billings or collection basis, and Paramount shall have the right to change the method from time to time. In the event a statement is on a billings basis, Paramount shall have the right in subsequent statements to make adjustments for uncollected bills.

* * * * * * *

(c) In preparing and filing their tax returns, Paramount and Gulf & Western Industries, Inc. and their distributing subsidiaries shall have the sole right to take the full amount of whatever credits, deductions or other benefits that may be available to them throughout the world with respect to, or relating to, taxes and fees paid by them in connection with distribution of the Picture, and Partnership shall not have the right t share or participate in or to take any such credits, deductions or othe benefits as aforesaid.

* * * * * * *

18. (a) Partnership may assign its share of the receipts from th Picture provided that written notice of such assignment shall b promptly given to Paramount and that Paramount shall not be require or obligated to make payments or disbursements directly to more tha two such assignees at any one time. Except as herein provided Partnership shall not assign this Agreement without the written consen of Paramount.

(b) * * * Nothing contained herein shall be deemed or construed t limit or prevent Paramount from assigning or hypothecating all or portion of its share of the revenues derived hereunder, or as prohibitin or preventing Paramount from causing the Picture to be distributed i whole or in part through sub-distributors, selling agents o licensees, * * * except as otherwise specifically provided in this Agree ment.

19. Paramount may add titles to the Picture and to any publicity o advertising issued in connection therewith, indicating Paramount's and/o its parent's names, brands or trademarks and containing words, such a "PARAMOUNT PRESENTS", "A PARAMOUNT PICTURE", "PARA MOUNT PICTURES", etc., as Paramount determines.

* * * * * * *

21. * * * Paramount shall have the right to select from the Pictur such material as Paramount may desire for deposit in Paramount's stoc film library without any compensation to Partnership for material s selected. Any material so selected shall forever be and remai

Paramount's sole and exclusive property and Paramount shall have the right to use such footage or make such footage available to others in any motion picture photoplays and any considerations received by Paramount from others shall belong to Paramount exclusively.

Such agreement was signed by Mr. Filler on behalf of the partnership and called for theatrical exhibition to commence no later than November 25, 1977.

The distribution agreements for the other films were nearly identical to the "First Love" distribution agreement. The only relevant differences were some variations in dates of execution and exhibition, payment for advertising costs, apportionment of gross receipts, and time limits for financial statements. Such agreements for "The One and Only" and "Heaven Can Wait" were dated December 2, 1977, and theatrical exhibition was to commence on April 15, 1978, and July 1, 1978, respectively. Under the distribution agreement for "The One and Only," Balmoral was to pay Paramount $450,000 on or before June 30, 1978, for advertising costs, and the gross receipts were to be apportioned as follows:

> FIRST (a) Partnership shall receive a sum equal to one and three-quarter (1¾%) percent of gross receipts until such time as the Partnership shall have been paid pursuant to subparagraph FOURTH below an amount equal to the sum of $4,770,000 * * *
>
> * * * * * * *
>
> FOURTH: Thereafter, 100% of remaining gross receipts shall be paid to Partnership until Partnership has been paid the sum of $5,275,618 * * *
>
> FIFTH: Thereafter, any gross receipts remaining shall be apportioned as follows: Partnership—sums equal to 25% thereof, Paramount—sums equal to 75% thereof, provided, however, that in no event shall Partnership's said 25% share be less than such sums as would have been payable to it hereunder if participations in net profits were not deductible * * * and Partnership's share of the remaining gross receipts pursuant to this subparagraph FIFTH were 11% and if Partnership's said 25% share shall be so less, Paramount shall additionally pay to the Partnership on a continuing basis an amount equal to the sums by which it is so less.

The distribution agreement for "Heaven Can Wait" required Shelburne to pay Paramount $825,000 on or before June 30, 1978, for advertising costs, and the variations in the apportionment of gross receipts were as follows:

> FIRST: (a) Partnership shall receive a sum equal to one and three-quarter (1¾%) percent of gross receipts until such time as the Partnership shall have been paid pursuant to subparagraph FOURTH below an amount equal to the sum of $12,534,500 * * *
>
> * * * * * * *
>
> FOURTH: Thereafter, 100% of remaining gross receipts shall be paid to Partnership until Partnership has been paid the sum of $13,464,077 * * *

Additionally, apportionment of remaining gross receipts was substantially the same as set forth for "The One and Only."

The distribution agreements for "Grease," "Foul Play," and "Bears 3" were dated May 25, 1978. The initial exhibition date for "Foul Play" was August 1, 1978, one month after such date for the other films. Such agreements contained no advertising advance payment, but contained the following provision concerning accounting statements provided by Paramount:

> 16. (a) * * * Such statements shall be provided within 90 days of the close of the accounting period in question, provided, that the first said statement hereunder shall be provided 120 days after the close of the relevant period. * * *

Such agreement for "Grease" required variations in the apportionment of gross receipts as follows:

> FIRST: (a) Partnership shall receive a sum equal to one and three-quarter (1¾%) percent of gross receipts (other than those from free home network and syndicated television distribution) until such time as there shall be payable to the Partnership pursuant to subparagraph FOURTH below an amount equal to the sum of $8,179,600 * * * . At such time as the gross receipts are such that the remaining gross receipts payable to the Partnership pursuant to subparagraph FOURTH below and/or to be apportioned pursuant to subparagraph FIFTH below reach the level of $8,179,600 plus interest thereon at the rate of 8% per annum commencing on the date hereof, to the extent that gross receipts from free home network and syndicated television distribution are not necessary for such level of remaining gross receipts to be reached, Partnership shall also be entitled to receive a sum equal to four (4%) percent of such gross receipts from free home network and syndicated television distribution as are not so necessary for said level of remaining gross receipts to be reached, whether derived before or after said level of remaining gross receipts is reached. * * *
>
> * * * * * * *

> FOURTH: Thereafter, 100% of remaining gross receipts shall be paid to Partnership until Partnership has been paid the sum of $8,179,600 * * *
>
> FIFTH: Thereafter, any gross receipts remaining shall be apportioned as follows: Partnership—sums equal to 12½% thereof, Paramount—sums equal to 87½% thereof. * * *

The gross receipts provisions of the "Foul Play" agreement were the same as those in the "Grease" agreement, except that the dollar value in the "FIRST" and "FOURTH" subparagraphs was $6,695,000. Similarly, the terms for "Bears 3" were the same except that such dollar value was $5,682,300.

Payments due Balmoral and Shelburne were due with the relevant distribution statement. This timing was standard in the industry and was specifically set forth in the distribution agreements for "Grease," "Foul Play," and "Bears 3".

Pursuant to the distribution agreements, the partnerships sent letters to the movie laboratories directing them to hold for the benefit of Paramount or transfer "any part" of the film and sound material for which Paramount was the distributor. However, the entire film and sound material could only be transferred with the prior written consent of the partnership. All charges for services performed on behalf of Paramount were to be paid by Paramount. Additionally, no one, except the partnership, was to have access to the film and sound material without Paramount's written consent, and no one, including the partnership, could remove such material without Paramount's written consent.

On November 2, 1977, FWC signed two documents, concerning "First Love" and "The One and Only," entitled "Notice of Irrevocable Authority," and Balmoral signed two such notices. The effect of such documents was to allow Paramount to retain the funds due it under the acquisition agreement and thereby to avoid an unnecessary circular flow of money from Paramount to Balmoral, under the distribution agreement, then from Balmoral to FWC, pursuant to the purchase agreement, and finally, according to the terms of the acquisition agreement, from FWC back to Paramount. FWC and Shelburne signed similar documents for "Heaven Can Wait" on December 2, 1977, and for the other Shelburne motion pictures on May 25, 1978.

On November 2, 1977, Paramount assigned all of its interest in and the copyright of "First Love" to FWC. At the same time, FWC assigned a security interest in "First Love" to Paramount, including:

> 1. All motion picture rights as more fully set forth in the Acquisition Agreement * * *
>
> 2. All common law and/or statutory copyright, domestic and foreign, to be obtained by * * * [FWC] in the Photoplay together with all rights to renew or extend such copyright and the right to sue in either or both Assignor's or Assignee's name for past, present or future infringements of copyright.

On the same day, FWC assigned all of its rights in, and the copyright to, "First Love," subject to the Paramount security interest, to Balmoral. A similar series of documents were executed for each of the films involved herein. Such documents for "The One and Only" and "Heaven Can Wait" were executed on December 2, 1977, and for "Bears 3," "Foul Play," and "Grease" on May 25, 1978. All other relevant ancillary agreements, letters, and promissory notes referred to in the acquisition agreements, the purchase agreements, and the distribution agreements were properly executed.

On June 15, 1978, Paramount agreed to the followin modification to the acquisition agreements for the motio pictures acquired by Balmoral and Shelburne:

> Paramount hereby acknowledges and agrees that the failure of * * * [FWC] to make due and punctual payment of the Note as a result of an delay by the distributor of the Picture in rendering distribution stat ments for the first calendar quarter of 1978 and all prior periods, an remitting payments required to be made concurrently therewith, shall no be deemed to constitute a breach of the Sale Agreement or a defaul under the Security Agreement. Further, Paramount hereby extends th due date of the Note until such time as said statements are rendered an said payments are remitted by the distributor of the Picture, reservin all other of its rights under the Sale Agreement and Security Agreemen

On June 21, 1979, paragraph 1 of each of the distributio agreements was amended by deleting the $5,000 or then fai market value language and inserting in its place a fla $25,000 payment. Such amendments were recommended b

Paramount's counsel as a means of avoiding potential litigation.

The provisions in the purchase agreements between FWC and the partnerships dealing with the partnerships' long-term notes and the conditions under which they would convert from recourse to nonrecourse were the result of the "at-risk" rules contained in the Tax Reform Act of 1976. The guarantees executed by the limited partners were designed to insure maximum tax benefits for the limited partners.

The acquisition and purchase agreements were negotiated with Mr. Heyman representing FWC, and the distribution agreements were negotiated and enforced with him representing Balmoral and Shelburne. He continued to act as the primary negotiator for the partnerships when problems arose concerning Paramount's distribution activities. The major economic and financial reporting terms were negotiated; most other points were the standard terms Paramount employed in such agreements. During the negotiations, Mr. Heyman consulted with Mr. Eisenberg very frequently.

The acquisition, purchase, and distribution agreements for each motion picture were intended to be a package; it was always planned that Paramount would be the distributor of the motion pictures. Indeed, Paramount would not have sold the pictures without receiving the distribution rights. By entering into such packages, Paramount was achieving three objectives: it reduced its financial risk associated with each film, increased its ability to make more films by improved cash-flow, and utilized its distribution organization closer to its capacity.

Mr. Heyman wanted FWC to be perceived in the film community as an important company doing business involving major motion pictures. By acting as the "middleman" between Paramount and the partnerships, FWC was developing an on-going relationship with Paramount and creating the image of a company associated with major motion pictures.

On November 14, 1977, the date appearing on the Balmoral private placement memorandum, there were agreements in principle for network television sales for "First Love," in the amount of $2,000,000, and "The One and

Only," in the amount of $3,800,000. The network television license agreement for "First Love" was finalized in February 1978, and such agreement for "The One and Only" was finalized in June 1978. Network television agreements for "Bears 3" in the amount of $5,500,000, "Grease" in the amount of $6,190,000, and "Foul Play" in the amount of $3,500,000 were agreed to in principle by April 1978. License agreements for syndicated (non-network) television had not been agreed upon prior to the execution of the transaction documents involved herein. In January 1983, Paramount licensed domestic syndication rights to "The One and Only," "Foul Play," and "Grease." By September 1984, Paramount had licensed foreign syndication rights to all the films.

"First Love" was released on November 4, 1977, and "The One and Only" was released on February 3, 1978. The Shelburne motion pictures were released during the summer months of 1978—"Bears 3" on June 2, "Grease" on June 16, "Heaven Can Wait" on June 28, and "Foul Play" on July 19.

The Balmoral private placement memorandum stated that the purchase price of a unit in the partnership was $70,000 payable $30,000 upon subscription, $33,000 payable on June 1, 1978, and $7,000 payable on June 1, 1979. The two post-subscription payments were evidenced by promissory notes. Total capitalization was stated as $2,450,000. Under paragraph 6.5 of article VI of the articles of limited partnership, each limited partner agreed to guarantee partnership obligations up to a value equal to 130 percent of his interest in Balmoral. Pursuant to such paragraph, Mr Durkin executed a guarantee for "First Love" in the amount of $15,514.50 and a guarantee for "The One and Only" in the amount of $28,768. Such guarantees were delivered by Mr. Filler to FWC. The guarantees included the provisions that:

> 1. The Guarantor unconditionally and irrevocably guarantees the du and punctual payment of the principal of the [long-term] promissory Note, * * *
>
> 2. The Guarantor agrees that this constitutes a guaranty of paymen and waives any right to require that any action be brought by the Seller for payment of any amounts due and owing to Seller from the Purchase with respect to the Picture.

The private placement memorandum for Shelburne was not issued until April 12, 1978. The purchase price of a unit in Shelburne was $316,000, payable $130,000 at the time of execution of the subscription agreement, $125,000 on June 1, 1979, and $61,000 on June 1, 1980. The two post-subscription payments were evidenced by promissory notes. Total capitalization was stated as $11,060,000. Pursuant to paragraph 6.5 of article VI of the articles of limited partnership, each limited partner had to guarantee partnership obligations up to a value equal to 225 percent of such interest.

The Balmoral private placement memorandum contained the following passage:

> COMPENSATION OF GENERAL PARTNERS
>
> The following table itemizes all of the types and estimated amounts of compensation payable to the General Partners. All such items were fixed solely by the General Partners and have *not* been determined by arm's length negotiations:
>
> *Guaranteed Payments*
>
> The General Partners will receive fees in 1977, 1978 and 1979 from the Partnership for their services and expenses in creating the Partnership and this private placement. The General Partners, in turn, will utilize a portion of these fees to pay legal, accounting and other expenses in connection with the organization of the Partnership and this Offering, estimated at $158,500, and the fees of offeree and other representatives, if any. The balance, approximately $300,000, will be divided between the General Partners as follows: $275,000 to Capital B Corporation, and $25,000 to Bernard M. Filler.
>
> $458,500
>
> *Annual Overhead, Administrative and Service Fee*
>
> The General Partners will be entitled to receive an annual overhead, administrative and service fee equal to 2% of the Partnership's cash flow after satisfaction of Partnership obligations for which they will provide the Partnership with office facilities, administrative services and all other indirect expenses not relating to the acquisition of the Pictures and the investment in CC-PE.
>
> No estimate
>
> [Fn. refs. omitted.]

The Shelburne private placement memorandum contained similar provisions. The Shelburne guaranteed payments totaled $2,087,050. Approximately $755,000 would be spent on expenses incurred in connection with establishing the partnership, negotiating contracts, and preparing the private placement memorandum. Of the remaining payments, $1,332,050, Capital B was to receive $1,282,050 and Mr. Filler was to receive $50,000. These payments were compensation "for their services and expenses relating to this private placement." The annual overhead provision was the same in both private placement memorandums.

Both such private placement memorandums stated that the general partners would sell units only to a person who made a written representation that, inter alia, he had a net worth, exclusive of home, furnishings, and automobiles, in excess of $1 million if he was purchasing one unit, or 50 percent thereof if he was purchasing one-half unit.

The private placement memorandum for Shelburne contained the following statement:

> The General Partners have been advised that an agreement has been entered into licensing the network television exhibition of "Foul Play" for two showings in return for a fee of $3,500,000. This picture will be available for telecast three years after theatrical release and payment will be made two-thirds upon the first telecast and one-third upon the second telecast. Network television sales for "Grease" and "Bad News Bears Go To Japan" are currently being negotiated, however, no agreements have been reached.

The Shelburne motion picture purchase agreements required substantial cash outlays by Shelburne before the partnership was fully capitalized. The necessary cash was provided by a loan from the Delta Partnership (Delta). Under the terms of such loan, dated April 5, 1978, Shelburne received $2,135,000: $2,084,000 on or before June 30, 1978, and $54,500 on or before June 30, 1979. Such loan was secured by Shelburne's rights in its four motion pictures and was evidenced by two promissory notes, due June 30, 1986, and bearing 9½ percent interest per year. Additionally, under the loan agreement, Delta received a "bonus payment" in the amount of 10 percent of all worldwide nontheatrical[7] gross receipts received by the distributor of the films. The terms were negotiated by Mr. Eisenberg and Mr. Filler; they were not negotiated at arm's length.

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[7] Nontheatrical gross receipts are those receipts from exploitation of a motion picture other than in a movie theater.

Delta was a partnership composed of CMS Investors (CMS), with a 95⅓ percent interest, and Megaventure, with a 4⅔ percent interest. CMS was owned by members of the law firm, or trusts or partnerships associated with them; partners owning approximately 90 percent of CMS had an interest in Capital B. Mr. Eisenberg was one such partner. In June 1978,[8] CMS borrowed $2,100,000 from four Netherlands Antilles corporations. The loans carried an interest rate of 9 percent until the due dates in 1980, when the rate increased to 13 percent. Such funds were used by CMS for its capital contribution to Delta. Delta then loaned nearly all of such funds to Shelburne.

Zeeuwse Maatschappij N.V. (Zeeuwse), a Netherlands Antilles corporation, loaned CMS $1,100,000 of the funds which it contributed to Delta. In April 1981, Delta sold Zeeuwse a portion of its interest in its bonus payment for $1,400,000; Delta assigned all its rights in the four films except "its interest in free home network and pay or subscription television, CATV or music royalties."

In the spring of 1978, Mr. Heyman sent Mr. Arney a letter stating that the final cost statement for "The One and Only" indicated a direct cost of $3,096,000, which, with overhead and interest, brought the total cost substantially below the cost warranted by Paramount in the acquisition agreement. In such letter, Mr. Heyman requested the return of the appropriate amount of FWC's initial payment and the appropriate reduction in the purchase price. Paramount agreed, resulting in a $119,250 rebate to FWC and new purchase terms: purchase price of $4,293,000, a recourse promissory note for $87,750 due on December 20, 1977, and a nonrecourse interest-bearing note for $3,669,750 with a maturity date of June 30, 1986. Balmoral received a cash rebate, and corresponding changes were made in the purchase agreement: the consideration was $4,393,000, $92,750 payable on or before June 30, 1978, and a recourse 8-percent interest-bearing note for $3,669,750 with a maturity date of June 30, 1986.

In 1977, Balmoral made a guaranteed payment of $25,000 to Mr. Filler. From 1977 to 1980, Balmoral made

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[8] The loan agreement with N.V. Zwaluw was executed on Dec. 22, 1978. Such agreement recites that the subject funds were made available to CMS on June 6, 1978.

$281,219.06 in guaranteed payments to Capital B: $232,500 in 1977, $34,788.19 in 1978, $7,692.97 in 1979, and $6,237.90 in 1980. Balmoral reported a current deduction for all such payments on its returns for such years, except for $20,000 to Capital B in 1977 which was a syndication cost. Of the guaranteed payments, $4,787.92 of the amount paid in 1978, and all of the amounts paid in 1979 and 1980, were for the annual overhead, administrative, and service fee equal to 2 percent of Balmoral's cash-flow.

Shelburne paid Mr. Filler the $50,000 in guaranteed payments referred to in its private placement memorandum in 1978, he received $34,000, and in 1979, he received $16,000. Capital B received $1,647,953.31 in guaranteed payments: $855,500 in 1978, $758,392.85 in 1979, and $34,060.46 in 1980. Shelburne reported a current deduction for all such payments, except $58,250 to Capital B in 1978 which was a syndication cost, on its returns. Of the guaranteed payments, $324,342.85 of the amount paid in 1979, and all of the amount paid in 1980, were for the annual overhead, administrative, and service fee equal to 2 percent of Shelburne's cash-flow.

Balmoral paid $160,523.68 in legal fees from 1977 through 1980. The law firm was paid $147,927.98 as follows $116,576.57 in 1977, $22,554.33 in 1978, $5,377.31 in 1979 and $3,419.77 in 1980. In 1977, $8,040 was paid to Taft & Kaminsky, and $4,555.70 was paid to Friedman & Koven During the same time period, Balmoral paid $35,806.42 in fees to accountants. Weiss & Co. received $24,759.42 as follows: $12,350 in 1977, $2,250 in 1978, $5,534.42 in 1979 and $4,625 in 1980. Solomon, Finger & Newman was paid $11,047 in 1980. Balmoral deducted all of the payments as professional fees, except for $28,132.27 for 1977. Of such amount, $22,500 was capitalized as organization cost $4,550 was classified as syndication cost, and $1,082.27 was reported as miscellaneous expenses. Balmoral elected to amortize such organization cost over a period of 60 months and claimed deductions for amortization expense of $750 for 1977 and $4,500 for each of the years 1978, 1979, and 1980

Shelburne paid $727,592.67 in legal fees from 1978 through 1980. The law firm was paid $699,171.45 as follows $451,498.88 in 1978, $239,650.52 in 1979, and $8,022.05 in

1980. In 1978, $20,910 was paid to Taft & Kaminsky, and $7,511.22 was paid to Friedman & Koven. During the same time period, Shelburne paid $74,078 in fees to accountants. Weiss & Co. received $51,448 as follows: $23,500 in 1978, $13,998 in 1979, and $13,950 in 1980. Solomon, Finger & Newman was paid $22,630 in 1980. Shelburne deducted all of the payments as professional fees on its returns for the appropriate year, except for $62,500 paid in 1978. Of such amount, $55,000 was capitalized as organization cost, and $7,500 was recorded as syndication cost. Shelburne elected to amortize such organization cost over a period of 60 months and claimed deductions for amortization expense of $8,250.00 for 1978 and $11,000 for each of the years 1979 and 1980.

Balmoral reported gross receipts of $12,500 for 1977, $1,761,432.95 for 1978, $943,108 for 1979, and $1,336,372 for 1980. Balmoral reported a loss of $2,589,074.12 for 1977, a loss of $2,810,978.90 for 1978, a loss of $22,136.76 for 1979, and ordinary income of $526,380.35 for 1980. Shelburne reported no gross receipts for 1978, and gross receipts of $43,023,941 for 1979 and $3,385,580 for 1980. Shelburne reported a loss of $14,871,963.80 for 1978, ordinary income of $34,247,881 for 1979, and a loss of $3,653,249 for 1980.

For purposes of the investment credit, Balmoral claimed qualified investment of $2,571,000 for "First Love" on its return for 1977, and $4,393,000 for "The One and Only" on its 1978 return. On its return for 1978, Shelburne claimed qualified investment of $12,734,500 for "Heaven Can Wait," $8,429,600 for "Grease," $6,845,000 for "Foul Play," and $4,369,630 for "Bears 3." The amount of qualified investment claimed for each film equaled the stated purchase price of the film by the partnership, except in the case of "Bears 3" where the qualified investment was reduced by the amount of foreign costs incurred to produce the film.

In the "First Love" distribution report for the period ended September 23, 1978, the cost of domestic prints is listed as $274,855 and deferments are stated as $45,000. The distribution report for "The One and Only" for the period ended September 23, 1978, listed additional print costs of $604,011 and deferments of $362,500. Such print costs and deferments were reflected on Balmoral's amended return for 1978. On such return, an increased qualified investment of $1,286,366 was reported. Similar information was reflected on Balmoral's amended return for 1980. On such return, an additional qualified investment of $124,258 for additional prints and deferments was reported, $6,798 of which related to "First Love," and $117,460 of which related to "The One and Only."

Shelburne filed amended returns for 1979 and 1980. The amended return for 1979 reported an additional qualified investment of $6,568,464. This amount included print costs, union and guild payments, deferments, and participations reported in the distribution statements for all of the Shelburne films. The amended return for 1980 reported an additional qualified investment of $591,417.

Balmoral reported depreciation expenses of $1,948,686.8 for 1977, $3,835,819.08 for 1978, $529,614.06 for 1979, and $510,599.98 for 1980 on the appropriate partnership return. These amounts were calculated by applying the income-forecast method using Paramount's gross receipts from the Balmoral motion pictures without including network television rentals. Shelburne reported depreciation expenses of $12,760,822.22 for 1978, $6,123,491 for 1979, and $6,123,49 for 1980 on the appropriate partnership return. On its return for 1978, Shelburne used the double-declining balanc method for computing depreciation. For years after 1978 Shelburne used the straight-line method of depreciation with a 4-year useful life.

Capital B engaged a New York accounting firm with expertise in motion picture auditing, Solomon, Finger & Newman, to perform audits of Paramount's distributio records relating to the pictures owned by Balmoral and Shelburne. Review of such audits and followup negotiations with Paramount by Mr. Heyman resulted in the recovery of money, which they would not otherwise have received, by the partnerships. Additionally, Messrs. Eisenberg and Fille reviewed the distribution statements from Paramount. Such review and the resultant negotiations with Paramount usually by Mr. Heyman, resulted in the recovery of money by the partnerships.

During 1979, the long-term notes for "Foul Play," "Grease," "The One and Only," and "Heaven Can Wait" converted from recourse to nonrecourse and, consequently, the limited partners' guarantees associated with such motion pictures were canceled and returned to them. On August 19, 1982, Mr. Filler, on behalf of Capital B, informed FWC that the long-term note for "First Love" had converted from recourse to nonrecourse. At such time, the limited partners' guarantees associated with such film were canceled. As of September 1984, despite the fact that such notes converted 2 years before, such notes had not been paid in full. Similarly, the long-term notes associated with "The One and Only" had not been paid in full by September 1984. By such time, the long-term notes for "Grease," "Foul Play," and "Heaven Can Wait" had been paid in full. As of such date, the long-term notes for "Bears 3" had not converted.

After the investors had become partners in Shelburne and the four Shelburne motion pictures had been released, some of such motion pictures were shown privately to the partners and their families by Shelburne at the Edens Theaters in Northbrook, Illinois. Such showings were catered and were held in recognition of the substantial investments made to Shelburne by the investors. Shelburne incurred various expenses in connection with the screenings, including costs for rental of the theaters and catering. Such costs were reported to be $4,859.40 and were deducted as "rent" on Shelburne's 1978 return.

Mr. Grossman has been an accountant for over 24 years. He formed a partnership named Good News Boys (GNB), which invested in the motion picture "Bears 2" by becoming a limited partner in Ambassador Associates. In May 1978, GNB acquired one unit in Shelburne; Mr. Grossman executed all relevant documents on behalf of GNB. GNB received distribution checks from Shelburne in the amounts of $349,156.88 in 1979, $46,254.10 in 1980, $5,690 in 1981, and $2,220 in 1983. In addition, GNB was relieved of its obligations to pay capital contributions due in June 1979 and June 1980, resulting in constructive dividends of $186,000.

Prior to his receipt of information concerning Balmoral or Shelburne, Mr. Durkin had known Mr. Eisenberg for some time and had been an investor in other partnerships organized by him or the law firm. On December 16, 1977, after reviewing the private placement memorandum, Mr. Durkin subscribed to a one-half unit interest in Balmoral. The purchase price of such one-half unit was $35,000 and was payable in three installments: $15,000 at the time of subscription, $16,500 on June 1, 1978, and $3,500 on June 1, 1979. Promissory notes were executed for the 1978 and 1979 payments. Pursuant to instructions from Balmoral, Mr. Durkin dated documents December 14, 1977. Mr. Durkin received distribution checks from Balmoral in the amount of $4,783.12 in 1978, $5,223.65 in 1979, and $4,235.47 in 1980. He continues to receive such checks. Additionally, he was relieved of his obligation to pay the promissory notes due on June 1, 1979. Such relief resulted in a constructive dividend of $3,500.

Mr. and Mrs. Durkin reported Balmoral partnership losses of $35,877 for 1977, $28,483 for 1978, $307 for 1979, and $0, due to loss carryover, for 1980. They claimed an investment credit for the motion pictures with a cost or basis of $60,874.24 for 1978.[9] Mr. and Mrs. Grossman reported GNB partnership loss of $101 for 1978, income of $38,854 for 1979, and loss of $75,032 for 1980. They claimed an investment credit for qualified investments by GNB with a cost or basis of $89,735 in 1978, $73,560 in 1979, and $14,689 in 1980. In his notices of deficiency, the Commissioner disallowed in full the losses and investment credits claimed by the Durkins and Grossmans.

OPINION

Many persons have invested in partnerships like Balmoral and Shelburne that purchased interests in the negatives of motion pictures. This case has been selected as a test case with the hope that it will resolve all the issues involved in the similar cases.

The first issue for decision is whether Balmoral and Shelburne became the owners of their respective motion pictures for purposes of computing allowable depreciation. For the years 1977 and 1978, the Commissioner raised such issue after issuing the notices of deficiency. For the years 1979 and 1980, such issue was raised in the notices of deficiency. Therefore, the Commissioner bears the burden of proof with respect to this issue for the years 1977 and 1978, and the petitioners bear such burden for 1979 and 1980. Rule 142(a), Tax Court Rules of Practice and Procedure.[10]

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[9] Mr. and Mrs. Durkin do not claim an investment credit for "First Love" in 1977.

The Commissioner argues that by virtue of the distribution agreements, Paramount acquired the irrevocable right to exploit the films, throughout the world, for their entire economic lives, if not in perpetuity. As a result of such agreements, the partnerships conveyed to Paramount all substantial rights in the motion pictures, and retained no interest upon which a deduction for depreciation can be based. Therefore, the amount received by the partnerships as a result of Paramount's exploitation of the films was a return of basis, and the excess, if any, was ordinary income. The petitioners contend that the partnerships owned the six motion pictures involved in this case. Such ownership arose through the purchase and acquisition agreements and was retained by the partnerships because the distribution agreements reserved certain critical substantial rights for the partnerships.

Whether the partnerships became the owners of the motion pictures for tax purposes as a result of the transactions involved herein is a question of fact to be determined by reference to the written agreements read in light of the attending facts and circumstances. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981); *Miller v. Commissioner*, 68 T.C. 767, 776 (1977); see *Fields v. Commissioner*, 14 T.C. 1202, 1210-1213 (1950), affd. 189 F.2d 950 (2d Cir. 1951). It is well established that the economic substance of a transaction rather than the form in which it is cast is determinative of its tax consequences. See *Golsen v. Commissioner*, 54 T.C. 742, 754 (1970), affd. 445 F.2d 985 (10th Cir. 1971), and the cases cited therein. Thus, in a number of cases, courts have refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of the property where the transferor continues to retain significant control over the property transferred. E.g., *Helvering v. Clifford*, 309 U.S. 331 (1940); *Helvering v. F. & R. Lazarus Co.*, 308 U.S. 252 (1939); *Law v. Commissioner*, 86 T.C. 1065 (1986); *Hilton v. Commissioner*, 74 T.C. 305 (1980), affd. 671 F.2d 316 (9th Cir. 1982); *Miller v. Commissioner*, *supra* at 767. "[T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930). It is therefore fundamental that the availability of a depreciation deduction is not predicated on the mere holding of legal title to property but rather upon a capital investment in the property. *Gladding Dry Goods Co. v. Commissioner*, 2 B.T.A. 336 (1925).

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[10] Any reference to a Rule is to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

Ownership of a motion picture negative is distinct from ownership of the copyright thereto (17 U.S.C. sec. 27 (1976); 17 U.S.C. sec. 202 (1982) (effective Jan. 1, 1978); *Michael Todd Co. v. Los Angeles County*, 57 Cal. 2d 684, 371 P.2d 340, 21 Cal. Rptr. 604 (1962), and cases cited therein), and ownership of the former without possession of at least certain of the rights encompassed by the latter is commercially valueless (see *Misbourne Pictures Ltd. v. Johnson*, 189 F.2d 774, 776 (2d Cir. 1951)). Copyrights are monopolies; "they entitle the owner to prohibit various kinds of reproduction, and to relieve individuals of these prohibitions by licenses." *Goldsmith v. Commissioner*, 143 F.2d 466, 467 (2d Cir. 1944) (Hand, J., concurring), affg. on other grounds 1 T.C. 711 (1943). With respect to a motion picture, the exclusive rights that comprise the so-called "bundle of rights" that is a copyright are the rights to: produce copies of the motion picture, prepare derivative works based upon the motion picture, distribute copies of the motion picture to the public by sale or rental, exhibit the motion picture to the public, and display still photographs taken from the motion picture to the public.[11] 17 U.S.C. sec. 1 (1976); 17 U.S.C. sec. 106 (1982) (effective Jan. 1, 1978). Such rights may be subdivided indefinitely and may be owned and enforced separately. 17 U.S.C. sec. 201(d) (1982) (effective Jan. 1, 1978). The copyright for "First Love" has a 28-year term, and the copyright for each of the other motion pictures has a 50-year term. 17 U.S.C. sec. 24 (1976); 17 U.S.C. secs. 302, 303 (1982).

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[11] Such right to display was not given copyright holders by statute before Jan. 1, 1978, and therefore, does not apply to "First Love." This distinction is not important to our decision in this case.

For tax purposes, a sale of a motion picture occurs when there is a transfer of all substantial rights of value in the motion picture copyright. *Tolwinsky v. Commissioner*, 86 T.C. 1009, 1042-1043 (1986), and the cases cited therein. No sale occurs if the transferor retains substantial proprietary rights in the motion picture. See *Carnegie Productions, Inc. v. Commissioner*, 59 T.C. 642, 653 (1973); *Cory v. Commissioner*, 23 T.C. 775 (1955), affd. 230 F.2d 941 (2d Cir. 1956).

An examination of the various written agreements reveals that the partnerships acquired and retained no substantial ownership rights in the motion pictures. Under the acquisition agreements, FWC purportedly obtained from Paramount a copyright, without sequel rights, for each motion picture. FWC purportedly transferred all such rights to the partnerships. The partnerships, according to the distribution agreements, then transferred back to Paramount all of the basic rights associated with a copyright, while retaining a "bare" copyright. For each motion picture, all the documents evidencing such transactions were executed at the same time. This series of transfers resulted in Paramount's having the rights to make copies of the motion pictures, to distribute copies of the motion pictures to the public, to show the motion pictures to the public, and to otherwise exploit any dramatic material contained in the motion pictures. Such rights applied to theatrical exploitation, pay television, video cassettes, and commercial television throughout the world. Such enumerated rights combined with Paramount's retention of motion picture sequel rights provided Paramount with the entire bundle of rights that is a copyright.

The transactions also resulted in Paramount's retaining rights and liabilities commonly associated with ownership. Paramount had the right to designate the laboratory that made copies of the motion pictures, and it was to pay all the costs related to storage and the making of copies. It had the right to determine the title of each film and th opening advertising and initial theatrical release of th motion pictures in the United States and Canada. Paramount could sue in its own name for copyright infringement. It was given exclusive worldwide rights to th soundtrack of the films and could license such rights Paramount could add its name to the picture and related advertising in such phrases as "A PARAMOUNT PICTURE. Paramount could select such material as it desired from th motion pictures for deposit in its stock film library without compensation to the partnership, and such material was t remain Paramount's property in perpetuity. Finally, there i no credible evidence that the partnerships had any contro over exploitation of the motion pictures.

Our conclusion that Paramount retained all substantia rights in the motion pictures is further supported by th fact that Paramount retained a significant financial interes in and control over the motion pictures and their proceeds Paramount held $31,843,050 of FWC's long-term nonrecours notes from FWC's acquisition of the motion pictures. B virtue of the notices of irrevocable authority, Paramoun was able to retain the funds that it would otherwise hav paid to the partnerships, that the partnerships would the have paid to FWC, and that FWC would then have paid t Paramount. There was no limit placed on the amount o profit Paramount could receive from its distribution efforts Additionally, all relevant witnesses agreed that Paramoun would not have sold the motion pictures if it could no distribute them. Paramount's financial interest combine with its tremendous control over exploitation of the film clearly indicates that it had all the rights and responsibilities of ownership.

The petitioners argue that the potential payment to b made by Paramount to the partnership at the end of ever 28-year period in order to extend the distribution agreemen is a "renewal price" indicative of the partnership's owne ship of its respective motion picture because Paramoun had to make a payment every 28 years for the privilege o distributing such motion picture. We conclude that th payments are of little value and thus we disagree. According to the terms of the distribution agreement, Paramount' distribution rights for each motion picture are to last in perpetuity, and at the beginning of each successive 28-year period, if the proceeds payable to the partnership under subparagraph "3 FOURTH" reach $5,000,000, Paramount is to pay the partnership the greater of $5,000 or the fair market value of the motion picture. The payment amount was later amended to a fixed amount of $25,000. Such payments are to be mere advances against further sums payable to the partnership pursuant to subparagraph "3 FIFTH" of the distribution agreement and are only payable upon 60 days' written notice by the partnership. These advances are not, as the petitioners argue, the renewal price for successive 28-year periods of film distribution. Such advances are only a change in the timing of payments and are small when compared to the multimillion dollar cost of each motion picture.

The petitioners contend that several other provisions in the distribution agreements indicate that the partnerships owned more than bare legal title and copyright to each of the motion pictures. The partnerships did not limit their contract remedy to default; the distribution agreements did not preclude a remedy whereby the partnerships could gain physical control over the motion pictures. In prior cases, such a limitation of remedies has been cited by this Court as support for the proposition that a taxpayer did not own a film. E.g., *Carnegie Productions, Inc. v. Commissioner*, 59 T.C. at 645. Additionally, Paramount cannot make an "outright sale" of its rights with respect to theatrical distribution in the United States and Canada. We observe, that while Paramount may not make such outright sale, it may make "outright territorial grants" anywhere in the world, and therefore, the restriction is one of form and not substance. Both of these provisions, under a different set of facts and circumstances, might support a taxpayer's claim of ownership for tax purposes of a film; however, under the facts and circumstances at hand, we conclude that such provisions, while protecting the petitioners' economic interests created by the transactions under review, simply do not constitute a legitimate claim of ownership.

A deduction for exhaustion and wear and tear is granted to a person who uses property in his trade or business and incurs a "loss resulting from depreciation of capital he had invested." *Helvering v. F. & R. Lazarus Co.*, 308 U.S. at 254. Depreciation "is not predicated upon ownership of the property, but rather upon an investment in property which is thereafter used. * * * The material elements are, the person who makes the investment, use of the property, and the period over which that investment is to be recovered out of income." *Gladding Dry Goods Co. v. Commissioner*, 2 B.T.A. at 338-339. An income interest dependent on the success of a motion picture may be subject to exhaustion over time in the same way that an investment in the motion picture itself would. *Law v. Commissioner*, 86 T.C. at 1100-1101; *Tolwinsky v. Commissioner*, 86 T.C. at 1053-1054.

The series of transactions between Paramount, FWC, and the partnerships resulted in the partnerships' obtaining a gross receipts participation and a net profits interest in the proceeds of Paramount's distribution efforts. The partnerships' gross participation was 1¾ percent until break-even, and 3 percent thereafter, with some variation for receipts from network and syndicated television for "Grease," "Foul Play," and "Bears 3." The partnerships' net profits interests are set forth in subparagraph "3 FIFTH" of each distribution agreement and range from a minimum of 11 percent to a maximum of 25 percent. As we did in *Law* and *Tolwinsky*, we conclude that such interests will exhaust over time and that, therefore, the partnerships are entitled to an allowance for depreciation.

On its returns for 1977, 1978, 1979, and 1980, Balmoral computed depreciation expense under the income-forecast method by using Paramount's gross receipts, excluding network television rentals, for "First Love" and "The One and Only" in the numerator and denominator. On its return for 1978, Shelburne computed depreciation expense using the double-declining-balance method of depreciation with 3-year useful lives for the motion pictures. For 1979 and 1980, Shelburne used the straight-line method of depreciation with 4-year useful lives. The Commissioner contends that Balmoral must use its own net income in the fraction appearing in the income-forecast method and should include estimates for network television rentals. Concerning the computation of depreciation expense for Shelburne, the Commissioner argues that it was not entitled to use the double-declining-balance method of depreciation for 1978 and that it made unreasonable estimates of the useful lives of the motion pictures in the computations for 1978, 1979, and 1980. The Commissioner contends that a reasonable useful life for the films, given the facts as we have found them, is 8 years. As we are clearly convinced of our conclusions, the burden of proof with respect to the method of computing depreciation is not material.

A contractual right to participate in a motion picture's gross receipts or net profits is an intangible asset. *Law v. Commissioner*, 86 T.C. at 1098-1101; *Tolwinsky v. Commissioner*, 86 T.C. at 1046-1053. Section 167 prohibits use of the double-declining-balance method to compute the allowable depreciation expense for intangible property, but allows the use of the straight-line method for such property. Generally, a change in a taxpayer's method of computing depreciation requires the consent of the Commissioner. Sec. 1.167(e)-1(a), Income Tax Regs.; see sec. 446(e). However, subject to certain limitations not applicable to this case, a taxpayer may change without the consent of the Commissioner from the declining-balance method of depreciation to the straight-line method at anytime during the useful life of the asset. Sec. 1.167(e)-1(b), Income Tax Regs. Additionally, the straight-line method of depreciation is to be used in all cases where the taxpayer has not adopted a different acceptable method of computing the depreciation expense of a depreciable asset. Sec. 1.167(b)-1(a), Income Tax Regs.

The income-forecast method requires the application of a fraction, the numerator of which is income from the motion picture for the taxable period, and the denominator of which is the estimated total income from the motion picture during its useful life. The cost of the motion picture is multiplied by such fraction to calculate the depreciation allowed for such taxable period.[12] Rev. Rul. 60-358, 1960-2 C.B. 68 (pertaining to television films), amplified to include

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[12] $$\frac{\text{Taxable period income}}{\text{Estimated total income}} \times \text{cost} = \begin{array}{c}\text{Depreciation}\\\text{allowed}\end{array}$$

The estimated income from the activity cannot be less than the sum of the investors' actual cash outlay plus any indebtedness, whether recourse or nonrecourse. Rev. Rul. 60-358, 1960-2 C.B. 68; Rev. Rul. 78-28, 1978-1 C.B. 61.

motion pictures, Rev. Rul. 64-273, 1964-2 C.B. 62. For such method, the term "income" means the taxpayer's net, rather than gross, income. *Gordon v. Commissioner*, 766 F.2d 293 (7th Cir. 1985), affg. a Memorandum Opinion of this Court; *Fife v. Commissioner*, 82 T.C. 1, 9 (1984); *Greene v. Commissioner*, 81 T.C. 132 (1983); *Siegel v. Commissioner*, 78 T.C. 659, 693 (1982). When the taxpayer elects to compute depreciation by use of the income-forecast method, he must use the method as prescribed by the Commissioner. *Greene v. Commissioner*, 81 T.C. at 139.

The petitioners call upon the Court to overrule a series of recently decided cases which clearly hold that when computing depreciation expense under the income-forecast method, the taxpayer must use his net income. They claim that consistent use of Paramount's gross receipts more accurately reflects the stream of income to the partnerships. However, the petitioners then go on to say:

> As the record shows, in order to calculate the *net* income from a film considerable information and analysis is required. In accordance with various agreements, there are numerous expenses and deductions from distributor's gross receipts, including participations, deferments, union and guild payments, prints, advertising expenses, etc., which must be taken into account to calculate net receipts. Accordingly, in order to determine net receipts, Weiss needed all such other expense and deduction information which information simply was *not* available at that time. * * * [Emphasis in original; fn. refs. omitted.]

Additionally, they argue that the use of gross receipts is more directly related to the actual depreciation of a motion picture.

During the years in question, Balmoral owned contract rights to funds derived from the commercial exploitation of two motion pictures. The actual depreciation of such motion pictures is not directly related to the appropriate depreciation expense of such contract rights. This proposition is clearly stated by the petitioners when they point out the numerous adjustments to gross receipts which must be made to calculate net receipts. Moreover, the petitioners failed to present any credible evidence that the relevant net receipts information could not be obtained prior to the filing deadlines for the partnership's returns. Therefore, Balmoral's net income should be used in the income-forecast computation.

Balmoral did not include network television rentals in the denominator of the income-forecast fraction. Rev. Proc. 71-29, 1971-2 C.B. 568, states that when using the income-forecast method of depreciation for motion pictures, such as those in question, the taxpayer need not estimate the income from future television exhibition. "However, if an arrangement for domestic TV exhibition is entered into prior to the time the cost of the motion picture has been depreciated to a reasonable salvage value, the Service will require an estimate of income from TV exhibition of such films to be made at that time." Rev. Proc. 71-29, 1971-2 C.B. at 569. The Commissioner contends that estimates for income anticipated from the agreements in principle for network television exhibition of the motion pictures should be included from the time of such agreements in 1977. At a minimum, the Commissioner argues that income estimates from network broadcasting should be included from the time such agreements were formalized by execution of contracts—February 1978 for "First Love," and June 1978 for "The One and Only." The petitioners contend that no estimate need be made until some payment is actually received by Balmoral from the networks because until that time, the amount is too speculative to be included in the denominator. We observe that the petitioners' argument conveniently allows greater early-year depreciation than is allowed by the plain language of the revenue procedure. Further, we observe that the logic of the petitioners' argument would render the income-forecast method useless because all future revenue, including box office receipts, would be considered too speculative. The agreements were with network television stations for motion pictures to be distributed by Paramount, a well known motion picture distributor, and were signed within 6 months of the transactions in question. Therefore, on the facts of this case, we must agree with the Commissioner that an estimate of income from network broadcasts should be included in Balmoral's income estimate for 1977 and thereafter.

Shelburne could not use the double-declining-balance method of depreciation for 1978, because the contract rights it owned in the motion pictures were intangible. Because it chose an unacceptable method of depreciation, the straight-line method will be used to compute depreciation expense for 1978. Testimony at trial indicates that syndication usually occurs 5½ years after the initial release. The Commissioner's 8-year useful life was based upon the maturity of the long-term notes in 1986; we find such maturity date of no relevance to the useful life of Shelburne's contract rights. Based upon the record as a whole, our best judgment is that 6 years is a reasonable useful life for Shelburne's contract rights.

The next question for our determination concerns the basis of depreciation of Balmoral's and Shelburne's contract rights. In general, the basis of property is the cost of such property. *Detroit Edison Co. v. Commissioner*, 319 U.S. 98 (1943); secs. 167(g), 1012. When debt principal is payable solely out of exploitation proceeds, nonrecourse loans are contingent obligations and are not treated as true debt. *Estate of Baron v. Commissioner*, 83 T.C. 542, 550-553 (1984), affd. 798 F.2d 65 (2d Cir. 1986); *Fox v. Commissioner*, 80 T.C. 972, 1022-1023 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. without published opinion sub nom. *Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner*, 734 F.2d 5-7, 9 (3d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984); *Saviano v. Commissioner*, 80 T.C. 955 (1983), affd. 765 F.2d 643 (7th Cir. 1985). When a transaction is structured in such a manner, that payment by the taxpayer is not probable, either because of the length or the terms of the debt, the source of the payments, or any other arrangement which does not provide an economic incentive for the taxpayer to pay the debt, then such debt is not genuine indebtedness to be taken into account for purposes of determining a taxpayer's investment in property. See *Tolwinsky v. Commissioner*, 86 T.C. at 1048-1050. Such a debt does not reflect an actual investment in property and cannot be included in the taxpayer's depreciable basis. *Siegel v. Commissioner*, 78

T.C. at 684-691; *Brannen v. Commissioner*, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984); *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), affd. 544 F.2d 1045 (9th Cir. 1976).

The Commissioner contends that the bases of depreciation in the motion pictures do not exceed $699,000 for "First Love," $1,173,250 for "The One and Only," $3,333,625 for "Heaven Can Wait," $2,294,900 for "Grease," $1,823,750 for "Foul Play," and $1,520,575 for "Bears 3." The Commissioner argues that the long-term notes from the partnerships are not includable in Balmoral's and Shelburne's bases because such notes represent contingent, illusory liabilities and because the purchase price of each motion picture unreasonably exceeded its fair market value. The petitioners state that such notes represent genuine indebtedness and that the purchase price of each motion picture, including the related promissory notes, was not substantially in excess of its fair market value.

The Commissioner contends that the petitioners were not "at risk" for the amount of the purportedly recourse promissory notes maturing in 1986 for which they executed guarantees. He argues that while Mr. Heyman rendered services in negotiating the transactions herein and resolving subsequent disputes, FWC was interjected into such transactions solely to create the appearance of "risk" with respect to such promissory notes. The Commissioner also claims that the events set forth in each purchase agreement whereby the partnership's long-term notes converted from recourse to nonrecourse were certain to occur. Finally, he submits that any amounts payable by virtue of the limited partners' guarantees was too contingent for the at risk rules, and that the possibility of indemnification from the general partner, Capital B, violates the at risk requirements.

The petitioners contend that they were at risk for the entire amount recited in the purchase agreement, including the amount of the notes maturing in 1986. They argue that Mr. Heyman is an independent party to the transactions herein and, on behalf of FWC, stands ready to enforce the guarantees and reap substantial additional profits for FWC. In support of this position, the petitioners observe that Mr. Barron did not like Mr. Eisenberg, Paramount was very cautious in its business dealings because of a Securities and Exchange Commission investigation, and FWC assumed a large risk even before the partnerships were formed. The petitioners state that the conversion events set forth in the purchase agreements were carefully negotiated by Messrs. Eisenberg and Heyman and were events with a substantial economic relationship to the motion pictures and which demonstrated the requisite degree of economic viability to satisfy the at risk requirements for conversion events. As such, they state that conversion events are similar to examples of bona fide conversion events which appear in the legislative history of section 465. S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 86 n. 1; H. Rept. 94-658 (1976), 1976-3 C.B. (Vol. 2) 695, 802 n. 10. The Commissioner concedes that he has the burden of proof on this issue for all years except for 1979 for Mr. and Mrs. Durkin.

Given the history of motion picture deals wherein Mr. Heyman and the law firm have worked together, the structure of the transactions in question, the lack of any services by FWC, and the tremendous increase in recourse debt which occurred in the transactions from FWC to the partnerships, this Court concludes that the partnerships' long-term notes and the guarantees of the limited partners were without business purpose and executed solely to gain tax benefits. Therefore, the long-term notes from the partnerships to FWC which mature in 1986 are disregarded for tax purposes. See *Goldstein v. Commissioner*, 364 F.2d 734, 740 (2d Cir. 1966), affg. 44 T.C. 284 (1965); see also *Knetsch v. United States*, 364 U.S. 361 (1960). However, we are persuaded that the amount of the short-term notes from FWC to Paramount is bona fide debt and that the short-term notes from the partnerships to FWC are bona fide, as are the promissory notes of the limited partners to the partnerships.

In support of our conclusion regarding the partnerships' short-term notes, we conclude on the record as a whole that Paramount entered into the transactions in question to receive an early return on its investment in the motion pictures, and it sought to insure this return by the use of recourse notes from FWC and similar notes from the partnerships to FWC. The existence of the nonrecourse long-term notes from FWC to Paramount underscores Paramount's desire to receive such early return. We are convinced that Paramount would have enforced FWC's short-term notes if the motion pictures had been unsuccessful. In the event of enforcement by Paramount, economic reality would have dictated that FWC would have to enforce the partnerships' short-term notes. Additionally, although the partnerships' short-term notes are for a larger amount than those of FWC, reflecting a markup for Mr. Heyman's services, we conclude that the full amount of the partnerships' short-term notes would have been enforced. By virtue of their promissory notes, the capital contributions of the limited partners would have provided the necessary funds. Compare *Pritchett v. Commissioner*, 85 T.C. 580 (1985) (Court-reviewed) with *Abramson v. Commissioner*, 86 T.C. 360 (1986) (Court-reviewed).

Our conclusion concerning the long-term notes is based in part upon the expectation of the law firm and the petitioners, at the time the parties executed the various relevant agreements, that such notes would convert regardless of the success of the motion pictures. Each of the Balmoral long-term notes convert to nonrecourse upon Paramount's receipt of sums due it upon the first syndicated (nonnetwork) television broadcast of the relevant motion picture. In effect, the conversion to nonrecourse occurs upon the payment of *any* money from *any* local television station. Mr. Heyman stated, as a rule of thumb, that syndication occurs 5½ years after theatrical release of a motion picture. One of the conversion events for "Heaven Can Wait" is the receipt by Paramount of more than $1,500,000 from cable and free home television. Mr. Heyman stated that the cable exhibition of a motion picture will usually commence 18 months after theatrical release. Mr. Arney testified that even a "fairly mediocre" motion picture will generate syndicated television revenues of $1,500,000. "Grease" has gross receipts from other than theatrical sources of $6,500,000 or more as a conversion event. Prior to execution of the FWC-Shelburne purchase agreement for "Grease," there was an agreement in principle to exhibit it on network television for $6,190,000. The motion picture "Foul Play" has Paramount's gross receipts from other than theatrical sources of at least $4 million as a conversion event. Prior to execution of its purchase agreement, there was an agreement in principle to exhibit "Foul Play" on network television for $3,500,000. "Bears 3" has as a conversion event Paramount's gross receipts of at least $6 million from nontheatrical sources. At the time of execution of its purchase agreement, there was an agreement in principle to exhibit "Bears 3" on network television for $5,500,000. Clearly, the occurrence of the conversion events was, while not certain, very likely.

The conversion events bore little relationship to the ability of the motion pictures to generate sufficient funds to pay off the converted notes. During 1979, partnership notes for "The One and Only," "Foul Play," "Grease," and "Heaven Can Wait" converted to nonrecourse. In 1982, the note for "First Love" converted. Despite the fact that each of these motion pictures was a success, in September 1984, the notes for "The One and Only" and "First Love" remained unpaid. There is no objective evidence in the record that supports the petitioners' contention that the conversion events were bona fide.

The structure of the transactions was designed to produce the appearance of "risk" within the meaning of section 465. The members of the law firm, including Mr. Eisenberg, were experts in tax law and the aspects of the entertainment law relevant to this case. They must have recognized that the partnerships were receiving bare legal title to the motion pictures. Despite this, they structured a series of transactions wherein the partnerships purportedly were at risk to FWC for $41,232,400 when they knew FWC was only at risk for $8,514,050. The larger amount clearly exceeded the fair market value of the rights the partnerships received. This tremendous increase in recourse debt was not the result of arm's-length negotiation; it resulted from the knowledge of Mr. Heyman and the law firm that the limited partners had to be personally liable on the debt in order to reap maximum tax benefits from the transaction. Given the long history of deals between Mr. Heyman and the law firm and the dominant position Mr. Eisenberg held in these transactions, we can only conclude that the transactions were structured with the expectation that the increased purportedly recourse debt of $32,718,350 would not be collected if the motion pictures were not successful.

We reach this conclusion even though we are fully aware of Mr. Heyman's statements at trial that he viewed the increase in recourse debt as an opportunity for FWC to make a tremendous amount of money and that he fully intends to enforce such debt for "Bears 3." Such opportunity is to present itself if the long-term notes do not convert to nonrecourse. Under the terms of their guarantees, the limited partners will have to pay the outstanding balance of such notes in 1986. However, FWC may keep the money and allow Paramount to repossess the motion picture. Given the close relationship between Mr. Heyman and the law firm, and the potential dissatisfaction of the limited partners with the law firm resulting from that action, we do not believe his testimony on this point.

We recognize that Mr. Heyman performed many valuable services for the partnerships. However, we conclude that FWC, as distinct from Mr. Heyman, did nothing for the partnerships except create some purportedly recourse debt, and further, we conclude that Mr. Heyman was, for tax purposes, acting as an agent for Capital B and the partnerships throughout the transactions at issue. Mr. Heyman owned WFS, which controlled FWC. Regardless of any unrelated undertakings FWC may have planned, the evidence is clear that, except for a few signatures on agreements, Mr. Heyman was the only representative of FWC in these transactions; he negotiated the acquisition agreements with Paramount, and he acted as chief negotiator for the partnerships when problems arose with Paramount's distribution activities. Prior to the transactions in question, Mr. Heyman had participated in many service company partnerships and negative pickup partnerships organized by the law firm.[13] Indeed, for a period of time, FWC had its office in the same building as the law firm. Mr. Bernstein, the president of FWC in years after the transactions in question were initiated, was involved in other activities with the law firm. In 1980, the law firm disbanded, and FWC ceased functioning in the United States because Mr. Heyman had divided loyalties following the law firm's breakup.

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[13] Mr. Heyman and the law firm were involved in the 1972 transactions at issue in *Estate of Helliwell v. Commissioner*, 77 T.C. 964 (1981).

Paramount desired to deal with Mr. Heyman; they had developed a good working relationship. There was no evidence that Paramount had any desire to deal with FWC. At trial, it was suggested that by selling motion picture rights to a corporation, such as FWC, rather than a partnership, like Balmoral or Shelburne, Paramount avoided the inconvenience of and possible legal problems associated with dealing directly with a limited partnership. Such inconvenience to Paramount arises from frequent contacts by individual limited partners. However, Paramount dealt directly with these same limited partnerships when it entered the distribution agreements. In fact, Paramount's distribution activities were ongoing activities for the partnerships, while the sales to such partnerships would not have been, therefore, Paramount's distribution activities were more likely to produce inquiries by individual limited partners than were direct sales. At trial, Mr. Arney stated that there were no special, important legal problems in dealing directly with a partnership. Therefore, we find this argument unpersuasive.

In summary, we believe the "true" cost of the movies to the partnerships was, except for Mr. Heyman's fee, equal to the cash and short-term notes paid by FWC. The amount represented by the long-term nonrecourse notes of FWC was designed merely to provide a flow of funds to the owner of the motion pictures, Paramount, while providing the appearance of ownership by the partnerships. Finally, the difference between the cash and short-term notes paid by FWC to Paramount and the cash and short-term notes paid by the partnerships is FWC's, more precisely Mr. Heyman's, fee for arranging the transactions and providing certain services in later years. On the record before us, we cannot determine what amount, if any, is currently deductible.

In his notice of deficiency for Mr. and Mrs. Durkin for 1978, the Commissioner disallowed the investment credit attributable to Balmoral. Such notice omitted an explanation for the disallowance. An explanation was provided in the amendment to answer. The Commissioner bears the burden of proving that his determination is correct. Rule

142(a). In the notice of deficiency issued to Mr. and Mrs. Grossman for the year 1978, the Commissioner disallowed all of the investment credit attributable to Shelburne claimed by Mr. and Mrs. Grossman. Mr. and Mrs. Grossman bear the burden of proof on this issue. Rule 142(a). Balmoral claimed additional qualified investment on amended income tax returns filed for 1978 and 1980, and Shelburne made similar claims on amended returns for 1979 and 1980. The petitioners claimed additional investment credits in unstated amounts in their petitions. The petitioners agree that they bear the burden of proof with respect to all additional qualified investment and investment credit.

A taxpayer is entitled to an investment credit under section 48 with respect to a motion picture film only if such film is "new section 38 property"[14] which is a "qualified film"[15] and only to the extent that the taxpayer has an "ownership interest" in such film. Sec. 48(k)(1)(A). A taxpayer may have an ownership interest in a motion picture for purposes of the investment credit even if the taxpayer has neither legal title to nor a depreciable interest in the motion picture. Section 48(k)(1)(C) provides that a taxpayer's ownership interest in a qualified film "shall be determined on the basis of his proportionate share of any loss which may be incurred with respect to the production costs of such film." The existence and extent of an ownership interest is determined at the time the film is placed in service. Sec. 1.48-8(a)(4)(ii), Income Tax Regs.; S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 230. Under section 1.48-8(a)(4)(iii) of the regulations, a taxpayer who, "at the time a film is first placed in service, is a lender or guarantor of all or a portion of the funds used to produce or acquire the film or part thereof" is regarded as having a depreciable interest for purposes of the investment credit if "he can look for repayment or relief from liability solely to the proceeds generated from the exhibition or disposition of at least a part of the film."

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[14] The Commissioner does not claim that the motion picture films discussed herein are not new sec. 38 property. A motion picture is new sec. 38 property until it is placed in service in any medium of exhibition in any geographical area of the world. Sec. 48(b); sec. 1.48-8(a)(2), Income Tax Regs. A motion picture is placed in service when it is first exhibited or otherwise utilized before the primary audience for which it was created. Sec. 1.48-8(a)(5), Income Tax Regs.

[15] The Commissioner does not dispute that the motion picture films discussed herein are qualified films. A qualified film is defined as "any motion picture film or video tape created primarily for use as public entertainment or for educational purposes. Such term does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature." Sec. 48(k)(1)(B).

"It is possible that more than one taxpayer may be entitled to a share of the credit for the same film." S. Rept. 94-938, *supra*, 1976-3 C.B. (Vol. 3) at 230. If a partnership has an ownership interest in a qualified film, its credit is apportioned among the partners on the basis of their percentage of capital at risk in the partnership at the time the film was placed in service. Sec. 1.48-8(a)(4)(iv), Income Tax Regs.

In the instant case, the expenses of producing the motion pictures were incurred by Paramount and were later partially reimbursed by FWC. The payments by FWC consisted of cash and recourse and nonrecourse notes. Such payments were made prior to the motion pictures' being placed in service and were made by FWC acting as agent for the partnerships. At the time of such payments, the partnerships paid cash and recourse and allegedly recourse promissory notes to FWC. Those promissory notes payable in 1986 have been found to be illusory, while the earlier notes are bona fide. The partnerships could look for repayment of such cash and bona fide promissory notes solely from proceeds generated by exhibition or disposition of the motion pictures; they were entitled to no guaranteed payments from Paramount.

The Commissioner contends that the partnerships did not have the required ownership interest in the motion pictures. In support of this contention, he argues that the partnerships transferred all substantial rights in the motion pictures to Paramount and retained no depreciable interest. Additionally, he argues that the partnerships are not lenders or guarantors within the meaning of the relevant regulations. The Commissioner's arguments were made prior to the release of our opinions in *Tolwinsky* and *Law*.

We conclude, that like the partnership in *Law*, Balmoral and Shelburne have satisfied the requirements of section 48(k)(1)(A) and are entitled to be treated as having an ownership interest. Each partnership was a "lender," within the meaning of the relevant regulations, which could look solely to exhibition or disposition of the motion pictures for repayment. This fact is evidenced by the modification of the acquisition agreements dated June 15, 1978, wherein Paramount agreed that a failure of FWC to make punctual payments on the notes due Paramount would not constitute a breach of such agreements if such failure was due to Paramount's failure to render distribution statements and concurrent payments through the first quarter of 1978. Additionally, our conclusion is supported by subparagraph 3 of the distribution agreements in which all payments to the partnerships are shown to be dependent on motion picture receipts. Compare *Law v. Commissioner*, 86 T.C. at 1106-1113 (ownership interest) with *Tolwinsky v. Commissioner*, 86 T.C. at 1063-1065 (no ownership interest).

The final question raised by the parties concerning the investment credit is the amount of each partnership's share of the production costs of such film. The Commissioner argues that the partnerships' qualified investment is limited to cash and bona fide recourse notes paid by the partnerships to FWC, less the markup attributable to Mr. Heyman's services. Additionally, the Commissioner states that if we determine that advertising costs are not currently deductible, they should be included in such qualified investment amount. The petitioners contend that the amount attributable to such services is includable because the petitioners are at risk for such amount.

The partnership's ownership interest is limited by the qualified U.S. production costs of the film. Such costs do not include fees for negotiations related to selling rights in the motion picture. Sec. 48(k)(5)(B). Therefore, the markup in price by FWC is not part of the production costs; the value of the cash and bona fide recourse notes from FWC to Paramount, less the amount of foreign costs incurred to produce "Bears 3," represents qualified U.S. production costs. We will address the proper classification of the advertising payments below.

On their amended returns, Balmoral claimed increased qualified investment in its motion pictures of $1,286,366 for 1978 and $124,258 for 1980, and Shelburne claimed increased qualified investment in its motion pictures of $6,568,464 for 1979 and $591,417 for 1980. The increases in reported qualified investment were based on print costs, union and guild costs, deferments, and participations reflected in the distribution reports from Paramount. Domestic prints, deferments, or union and guild costs were the basis of the increase claimed in each motion picture film for at least 1 year. Participations were the basis of such claim for at least 1 year for "Heaven Can Wait," "Grease," and "Foul Play."

An investment credit may be claimed in a year subsequent to that in which the film is placed in service, pursuant to section 1.48-8(e)(9) of the regulations. In relevant part, such regulation states that:

> The only costs incurred after a qualified film has been placed in service which are includible in production costs are the cost of preparing prints placed in service within 12 months after the film (or part) is initially released for public exhibition in any medium, residuals described in paragraph (e)(3) of this section,[16] and participations described in paragraph (e)(4) of this section.[17] * * *

Finally, a taxpayer may claim the additional investment credit with respect to such subsequently incurred costs, provided he has an ownership interest in the film at the time such costs are incurred. Sec. 1.48-8(a)(4)(ii), Income Tax Regs.

The Commissioner argues that Balmoral and Shelburne were not at risk with respect to any payments for print costs and union and guild costs. Under subparagraph "3 SECOND" of the distribution agreements, print costs for each film were part of the distribution advances recoupable by Paramount to the extent sufficient gross receipts were earned in excess of the partnership's gross participation and Paramount's distribution fees. Under subparagraph "3 FIRST", union and guild costs are deducted before the partnership's gross participation and Paramount's distribution fees are calculated. Therefore, the costs were not satisfied from funds due the partnerships, and the partnerships were not liable for such costs if the motion pictures did not generate sufficient revenue to cover such costs.

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[16] These are contingent compensation payments made pursuant to collective bargaining agreements, paid to creative and technical personnel, to their unions, or to pension, health, or welfare funds. The collective bargaining agreements generally cover all films produced over a period of years. Sec. 1.48-8(e)(3), Income Tax Regs.

[17] These are contingent compensation payments paid for the services of actors, production personnel, writers, composers, directors, and producers. These are generally negotiated on a film-by-film basis. Participations may be based on the gross or net income of a film. Sec. 1.48-8(e)(4), Income Tax Regs. Under sec. 1.48-8(e)(5), Income Tax Regs., the inclusion of participations in the credit base may not exceed the lesser of (1) the sum of 25 percent of each participation paid to each person (excluding the amount of any participation exceeding $1 million) for each film placed in service in the year, or (2) 12½ percent of U.S. production costs (other than residuals and participations) of all films placed in service in the year.

The Commissioner observes that the deferment[18] costs for the Balmoral motion pictures were payable after net profits or a stated amount over break-even was reached and that neither such motion picture had reached either such milestone as of late June 1983. He argues that the petitioners have not shown that such costs were incurred or paid. With respect to the participations and deferments related to "Heaven Can Wait," "Grease," and "Foul Play," the Commissioner concedes that the costs were incurred or paid, because all three films have reached net profits. However, he believes that Paramount and the partnerships should allocate such costs based on their shares of relative risk, as measured by shares of net profits. Shelburne's allocated deferments and participations would be $381,941 in 1979 and $58,574 in 1980.

The petitioners argue that although Paramount paid all print costs and union and guild costs, such costs were actually incurred by the partnerships. The distribution agreements allow Paramount to be reimbursed for such costs prior to certain payments to the partnerships. Therefore, the partnerships, not Paramount, bore the risk of loss resulting from these costs. The petitioners agree with the Commissioner's concession concerning the three Shelburne motion pictures, but only with respect to deferments and participations paid after recoupment by Shelburne of its costs for such pictures.

The petitioners have failed to meet their burden of proof concerning amounts not conceded by the Commissioner. We cannot find that the costs were paid or incurred by the partnerships or someone under their control. Clearly, Paramount paid or incurred the costs in question, and such costs adversely affected the partnerships' income opportunities. It is equally clear that the partnerships did not pay Paramount for incurring such costs. Given that the partnerships did not own the motion pictures, did not distribute such motion pictures, did not determine any of the costs, and, through the workings of the letters of irrevocable authority, only received payments which were net of costs, we conclude that these costs were too remote from the partnerships to be considered paid or incurred by them. In the context of a participation interest, we decline to define "paid" or "incurred" to include the diversion of funds to which the partnerships would have had some right if the underlying cost had not been incurred; the partnerships' interests in the proceeds of the motion pictures were net of these costs. Therefore, the petitioners are not entitled to investment credits beyond the amounts conceded by the Commissioner.

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[18] Such deferments apparently meet the definition of participations in sec. 1.48-8(e)(4), Income Tax Regs.

The Commissioner determined that Balmoral and Shelburne were not entitled to deductions in any amount for guaranteed payments to partners. The parties agree that the petitioners have the burden of proof on this issue.

Balmoral claimed deductions for guaranteed payments in the amounts of $237,575 for 1977, $34,988.19 for 1978, $7,692.97 for 1979, and $6,237.90 for 1980. Shelburne claimed deductions arising from guaranteed payments in the amounts of $831,250 for 1978, $774,393 for 1979, and $34,061 for 1980.

Section 707(c) allows a deduction to a partnership for guaranteed payments to partners. Such payments are determined without regard to partnership income and are payments to a partner for services or the use of capital. Sec. 707(c). To be deductible, the guaranteed payments must meet the requirements of section 162(a); they must be ordinary and necessary expenses, reasonable in amount, and incurred in a trade or business.[19] *Wildman v. Commissioner*, 78 T.C. 943, 960 n. 19 (1982); *Cagle v. Commissioner*, 63 T.C. 86, 91 (1974), affd. 539 F.2d 409 (5th Cir. 1976); sec. 1.707-1(c), Income Tax Regs.

In determining whether the payments in the present case are deductible under section 162(a), we look to the nature of the services performed by the general partners rather than to their designation or treatment by the partnership. *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179, 187 (1918); *Cagle v. Commissioner*, 63 T.C. at 96. Payments allocable to organizational costs and syndication expenses must be capitalized. Organizational costs, if elected, are amortizable over a 60-month period, but syndication costs are not amortizable. Secs. 263, 709; *Estate of Thomas v. Commissioner*, 84 T.C. 412, 441 (1985), and the cases cited therein; *Estate of Boyd v. Commissioner*, 76 T.C. 646, 658 (1981). The petitioner "bears the burden of proving what portion of the fee is allocable to nondeductible capital portions and to deductible expense portions (*Estate of Boyd v. Commissioner, supra*), and such allocation must reasonably comport with the value of the services performed." *Wildman v. Commissioner*, 78 T.C. at 958; see also *Merians v. Commissioner*, 60 T.C. 187 (1973). Any fee for services to be rendered in the future is not deductible in the year of expenditure. *Estate of Boyd v. Commissioner*, 76 T.C. at 667. Whether payments to a partner represent a reasonable compensation for services is a question of fact to be determined on the basis of the particular circumstances of each case. *Huckins Tool and Die, Inc. v. Commissioner*, 289 F.2d 549 (7th Cir. 1961), affg. a Memorandum Opinion of this Court. When the parties are related, the burden of demonstrating the reasonableness of compensation will not be lightly discharged. *Johnsen v. Commissioner*, 83 T.C. 103, 122 (1984), revd. and remanded on other grounds 794 F.2d 1157 (6th Cir. 1986).

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[19] Even if the partnerships were not engaged in a trade or business, such payments might be deductible by the partners under sec. 212. Although a partnership is not allowed a deduction under sec. 212, a partnership may incur expenses that may be deducted by an individual partner under sec. 212. Sec. 1.702-1(a)(8)(i), Income Tax Regs.; Rev. Rul. 75-523, 1975-2 C.B. 257.

The petitioners argue that the guaranteed payments made to Capital B and Mr. Filler are allowable as ordinary and necessary business expense deductions as compensation for the services rendered by the general partners. In support of this argument, the petitioners refer to the articles of limited partnership which provide that the general partners have full, exclusive, and complete discretion in the management and control of the partnerships. In discharging their duties, the general partners handled all administrative responsibilities of the partnerships. Additionally, the petitioners contend that the general partners undertook many risks on behalf of the partnerships, including liability for short-term notes to FWC.

Balmoral's private placement memorandum stated that the general partners would receive guaranteed payments from Balmoral "for their services and expenses in creating the Partnership and this private placement." Of such fees, approximately $275,000 was to be paid to Capital B and $25,000 was to be paid to Mr. Filler. Concerning guaranteed payments, Shelburne's private placement memorandum stated that Capital B would receive $1,282,050 and Mr. Filler would receive $50,000 "for their services and expenses relating to this private placement." The private placement memorandums of both partnerships stated that the general partners would receive an annual overhead, administrative, and service fee equal to 2 percent of the partnership's cash-flow after satisfaction of partnership obligations.

The plain language of the private placement memorandums clearly establishes that the payments from Balmoral in 1977 and 1978 and from Shelburne in 1978 and 1979, except for those based on the 2 percent of cash-flow, were for expenses in connection with organizing the partnership and the offering. Such payments are not currently deductible. The annual 2 percent of cash-flow fee is not deductible because the petitioners have failed to show that such fee is reasonable compensation for the services performed.

The petitioners have not proved to our satisfaction that the law firm, other than Mr. Eisenberg, provided any meaningful services for the partnerships. Additionally, we conclude that Mr. Filler did perform services for the partnerships. The expense for such services of both men would be currently deductible for the partnerships. Unfortunately, the petitioners have not provided us with a basis for valuing such services, and it is clear that such services were not worth 2 percent of the partnerships' cash-flow. Additionally, such fees were not the result of arm's-length negotiations between unrelated parties having adverse economic interests; the amount of such fees was supplied by Messrs. Eisenberg and Filler.

The Commissioner determined that advertising payments made by Balmoral in 1977 and 1978, and by Shelburne in 1978, to Paramount are not currently deductible, as they were part of the purchase price and should be capitalized. Section 162(a) allows a deduction for ordinary and necessary expenses incurred in carrying on a trade or business. Because the Commissioner first raised this issue in his notices of deficiency, the petitioners bear the burden of proving that the amounts claimed by them satisfy the requirements of this provision. Rule 142(a).

The Commissioner argues that the advertising payments described in the "First Love," "The One and Only," and "Heaven Can Wait" distribution agreements were actually part of the cash downpayment for each motion picture interest, although they were described as advertising payments in order to provide a current deduction for such payments. In support of his position, the Commissioner states that the other motion pictures in this case did not contain such a clause and neither did the motion picture in the Ambassador partnership. In the Paramount-FWC acquisition agreements for "Grease," "Foul Play," "Bears 3," and the Ambassador motion picture, the cash payments at or near execution and the short-term recourse notes equal 25 percent of the purchase price of each film; for "First Love," "The One and Only," and "Heaven Can Wait," the same percentage is reached only if the advertising expense is included with the cash and short-term recourse notes. The Commissioner asserts that this pattern indicates that Paramount sells a contract interest in its motion pictures for a fixed percentage, regardless of what the payment is called.

The Commissioner notes that Paramount treated the advertising payments as part of the purchase price. For financial reporting, Paramount reduced its investment in the motion pictures by amounts which included the advertising payments. In computing its qualified U.S. production costs for investment credit purposes, Paramount subtracted the advertising payments, at least for "First Love" and "The One and Only." Additionally, Paramount previously estimated that it would spend more than five times the amount set forth in the distribution agreements on advertising for the three films. In fact, within 8 months of their initial release, Paramount had incurred advertising expenses of $1,430,000 for "First Love," $3,770,000 for "The One and Only," and $13,830,000 for "Heaven Can Wait."

The petitioners contend that Balmoral and Shelburne wanted to make certain that Paramount spent sufficient

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funds on advertising the motion pictures. Paramount initially refused to commit to a minimum advertising amount, but finally agreed to spend at least as much as the partnerships gave them for advertising. Mr. Heyman then discussed the advertising campaigns with Paramount, and the partnerships made sure that the amounts were properly expended.

We conclude that the Commissioner's determination is correct. The petitioners have failed to persuade this Court by relying on uncorroborated and not readily believable reasons for incurring the advertising expenses. By contrast, the Commissioner's evidence is objective and believable.

Amounts paid or incurred to organize a partnership may, at the election of the partnership, be treated as deferred expenses and amortized over a period of not less than 60 months. Sec. 709(b)(1). Organizational expenses are expenditures which (1) are incident to the creation of a partnership, (2) are chargeable to capital account, and (3) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life. Sec. 709(b)(2). Examples of organizational expenses include legal fees for services incident to the organization of the partnership (such as negotiation and preparation of a partnership agreement), accounting fees for services incident to creation of the partnership, and filing fees. Sec. 1.709-2(a), Income Tax Regs.

The Commissioner determined that the partnerships were not entitled to amortization deductions for organizational costs in any amount for the years at issue. In the notices of deficiency, the Commissioner stated:

> It is determined that the amount claimed as amortization expense is not allowable because it has not been shown that the amount used as basis for calculating the expense was paid or if paid, that such amount is amortizable. Furthermore, it has not been shown that the underlying obligation was the taxpayer's liability or that the obligation was not subject to a contingency.

In the amended answer for Mr. and Mrs. Durkin's 1977 taxable year, the Commissioner stated:

> Subsequent analysis of the facts also indicates that Balmoral is not entitled to a deduction for the amortization expense claimed for 1977.

The Commissioner now concedes that the partnerships paid the amounts capitalized as organizational costs, that the obligations were the partnerships', and that the obligations were not subject to a contingency. His position is that the amounts allocated to organizational costs greatly exceeded the value of the services properly allocable to these costs. He argues that the law firm had provided organizational services for many similar limited partnerships in the past and "must have perfected its boilerplate language by the time Balmoral was organized." Further, the Commissioner states that the documentation produced first for Balmoral and then Shelburne was virtually identical, yet the organizational cost for Balmoral was $22,500 and such cost for Shelburne was $55,000.

The petitioners contend in their brief that the Commissioner does not dispute that the costs claimed by the partnerships were for organizational costs, as he did in the notices of deficiency and amended answer; the Commissioner simply states his unsubstantiated belief that the fees are unreasonable.

We agree with the petitioners that the Commissioner has conceded all the objections set forth in the notices of deficiency for disallowing the organizational costs, and the amendment to answer did not provide adequate notice to the petitioners of the valuation argument. Not until his brief did the Commissioner raise the valuation argument. Given such lack of adequate notice, and our belief that the Commissioner's valuation argument compels the petitioners to produce different evidence than the arguments set forth in the notices of deficiency and the pleadings, we think that consideration of the Commissioner's valuation argument would unfairly prejudice the petitioners. See *Estate of Horvath v. Commissioner*, 59 T.C. 551, 555-557 (1973), and the cases cited therein. Accordingly, we decline to consider such argument.

In his notice of deficiency to Mr. and Mrs. Grossman for 1978, the Commissioner disallowed the deduction for rent expense of $4,859.40 for 1978 claimed by Shelburne. Such deduction relates to the cost of private screenings of Shelburne motion pictures for the partners. Among the reasons given for the disallowance was the failure to prove that the amounts claimed were ordinary and necessary business expenses and that such amounts were obligations of the partnership which were paid by the partnership. Mr. and Mrs. Grossman have the burden of proving that the Commissioner's determination is incorrect. Rule 142(a).

The Supreme Court in *Welch v. Helvering*, 290 U.S. 111, 113 (1933), gave meaning to "ordinary and necessary expenses" as the terminology was used in the predecessor of section 162(a). The Court indicated that "necessary" means "appropriate and helpful" in "the development of the petitioners business." Whether an expenditure is ordinary and necessary is a factual determination. *Commissioner v. Heininger*, 320 U.S. 467 (1943).

In his brief, the Commissioner states that "once the investment was made, the die was cast. Screenings thereafter could affect neither the decision whether to invest nor the way the films were exploited by Paramount." While we agree with the Commissioner that expenses which inure to the benefit of partners must be carefully scrutinized, we conclude that the substantiated expenses were ordinary and necessary. The screenings and associated activities were, given the amount invested, relatively inexpensive, and they served the purposes of maintaining good relations between the partners and allowing them to become familiar with the major assets of the partnership.[20]

At trial, Mr. Filler testified that private screenings of the Shelburne motion pictures were held for investors and their families. He was not specific as to how many such screenings occurred or how much such screenings cost. A letter dated July 19, 1978, which was admitted into evidence, shows that "Foul Play" was to be privately shown at the Edens Theatre on August 6, 1978, and that The Mixing Bowl would cater such showing. Thirteen Shelburne checks, totaling $4,729.40, were admitted into evidence. Several checks had notations indicating that they were for payment of theater rentals and related screening activities, including the August 6, 1978, showing of "Foul Play." Checks totalling $2,547 were proved to be related to screening activities, and such amount is allowed as a deduction. Such checks were to the order of The Mixing Bowl, Edens I Theatre, Edens #2 Theatre, and Plitt Theaters Management, Inc. We observe that this is a small deduction in a very complex case; the parties should have settled the issue on an amicable basis.

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[20] We observe that Shelburne had merely a contractual right to proceeds from the motion pictures. However, the motion pictures are the source of all revenue to Shelburne.

The next issue for determination is whether the partnerships are entitled to deductions in any amount for professional fees for the years in question. In his notices of deficiency for all years, except Mr. and Mrs. Durkin for 1979 and Mr. and Mrs. Grossman for 1979 and 1980, the Commissioner determined that all such fees were not deductible because they were not ordinary and necessary, were expenses for which no timely election to amortize had been made, or were capital expenditures. The notice of deficiency sent to Mr. and Mrs. Durkin for 1979 contained a determination that all professional fees were not deductible. However, such notice of deficiency did not contain an explanation of such determination. The notices of deficiency sent to Mr. and Mrs. Grossman for 1979 and 1980 only contained the ordinary and necessary business expense reason. The burden of proof on this issue for each year and each petitioner will be allocated in accordance with the reasons provided in each notice of deficiency and the theory espoused by the Commissioner. Rule 142(a).

Balmoral claimed deductions for professional fees in the amounts of $113,390 for 1977, $24,804.23 for 1978, $10,911.73 for 1979, and $19,091.77 for 1980. Shelburne claimed deductions for professional fees in the amounts of $440,920.10 for 1978, $253,648.52 for 1979, and $44,602.05 for 1980. The Commissioner concedes the deductions claimed by Balmoral for payments to Weiss & Co. for 1978, 1979, and 1980, and the deductions claimed by Shelburne for similar payments in 1979 and 1980. He concedes all deductions for payments to Solomon, Finger & Newman. The petitioners concede the nondeductibility of $32,350 of professional fees paid by Balmoral to the law firm and Weiss & Co. in 1977, and $43,500 of professional fees paid by Shelburne to such payees in 1978 as syndication expenses. The petitioners also concede that $10,000 of the reported 1977 professional fees paid by Balmoral to the law firm, and $20,000 of the reported 1978 professional fees paid by Shelburne to the law firm should be capitalized and added equally to depreciable basis of each of the motion pictures. Additionally, the petitioners concede that all professional fees paid to Taft & Kaminsky should be added to the depreciable basis of the pictures. The parties agree that such addition is to be equal, on a per-motion-picture basis, within each partnership.

The petitioners argue that, with the exception of the amounts conceded by them, all of the professional fees incurred and paid are currently deductible under section 162 or section 212(3).[21] Concerning the initial year's professional fees for the partnerships, 1977 for Balmoral and 1978 for Shelburne, they request that we apply the *Cohan* rule and determine that such fees are currently deductible. In support of such request, the petitioners argue that because of the law firm's expertise, little time was needed to organize and syndicate these partnerships. The logical conclusion, according to the petitioners, is that the law firm's fees were for a wide variety of services which constituted ordinary and necessary business expenses. For the remaining years, the petitioners argue that such fees could not be organizational expenses because the partnerships were already in operation and, like the initial year's professional fees, were ordinary and necessary expenses arising from tax advice, negotiations with Paramount, and similar ongoing business activities.

The Commissioner contends that all of the professional fees reported on the partnerships' returns were incurred in connection with the organization of the partnerships and therefore, are not currently deductible. He supports this contention by pointing out that the amount of professional fees paid by each partnership in its first 2 years of operation is very close to what the private placement memorandums indicated would be paid for organization expenses. The Commissioner states that the petitioners presented no evidence to establish what portion of the professional fees are currently deductible. Therefore, he argues, the *Cohan* rule may not be applied. Additionally, he would have us find that none of the professional fees reported in later years are deductible.

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[21] See note 18 *supra*.

The *Cohan* rule was set down by the Second Circuit in *Cohan v. Commissioner*, 39 F.2d 540 (1930), revg. and remanding 11 B.T.A. 743 (1928):

> The teaching of the *Cohan* case is that where there is an evident right to a deduction but there is no showing of the exact amount of the deduction, the court is to determine the appropriate amount for the deduction, weighing its judgment heavily against the taxpayer who is responsible for the deficiencies in proof. *Bodoglau v. Comm[issioner]*, 230 F.2d 336 (CA 7th, 1956) * * * . [6 J. Mertens, Law of Federal Income Taxation, sec. 25.04 n. 6, ch. 25, at 15 (1985 rev.).]

However, where a petitioner has ready access to material evidence in support of an allegedly allowable deduction and fails to produce such evidence, it may not be appropriate to apply the *Cohan* rule. See *Rosenstein v. Commissioner*, 32 T.C. 230 (1959). Where proof is lacking of any deductible item, the *Cohan* rule is not to be applied. See *Crowley v. Commissioner*, 34 T.C. 333, 350 (1960).

We conclude that the legal fees paid to the law firm by Balmoral in 1977 and 1978 and Shelburne in 1978 and 1979 were substantially all for the organizational services referred to in the private placement memorandums. We conclude that the legal fees paid to the law firm by Balmoral in 1979 and 1980 and Shelburne in 1980 were for ongoing ordinary and necessary business services provided by Mr. Eisenberg and, therefore, were currently deductible. Mr. Eisenberg provided similar services for Balmoral in 1978 and Shelburne in 1979. We estimate the cost of such services as $5,377.31 for Balmoral in 1978. Such amount was incurred by Balmoral for Mr. Eisenberg's services in 1979. Similarly, we conclude that $8,022.05 is a reasonable estimate of the fees associated with Mr. Eisenberg's services for Shelburne in 1979. These amounts are deductible in the years incurred as ordinary and necessary business expenses.

The Balmoral private placement memorandum stated that approximately $158,500 from the offering proceeds would be used "among other things, to pay fees and expenses incurred or to be incurred in connection with establishing the Partnership, negotiating contracts for the acquisition and distribution of the Pictures, and preparation of this Memorandum" and as payment for "legal, accounting and other expenses [incurred] in connection with the organization of the Partnership and this Offering." The Shelburne private placement memorandum contained nearly identical language regarding the disposition of approximately $755,000. In 1977 and 1978, Balmoral reported professional fees totaling $151,726.60, and in 1978 and 1979, Shelburne reported professional fees totaling $719,570.62.

At trial, Mr. Filler, a long-time business associate of law firm members, was evasive as to the relationship between the services provided by the law firm and the fees it received from the partnerships. He indicated that at least some of such fees were meant to pay for organization and syndication costs. The amount of such fees was determined "By an assessment of the value of their services, time involved, expertise involved, the responsibility assumed[,] and the importance of their counsel in relationship to the enormous investment that would be made by limited partners in this transaction." None of the bills from the law firm identify the nature of the work performed beyond occasionally naming one of the motion pictures.

From the record, it is clear that Mr. Heyman carried out the vast majority of negotiations with Paramount and reviewed the distribution statements; Mr. Filler handled the administrative chores of the partnerships; and Paramount carried out distribution of the motion pictures. Solomon, Finger & Newman conducted special audits of Paramount, and Weiss & Co. prepared the financial statements and tax returns for the partnerships. It follows that professional fees paid to Weiss & Co. and not conceded by the petitioners are currently deductible in the appropriate years. It is also clear that Mr. Eisenberg occasionally contacted Mr. Filler, Mr. Heyman, and Paramount concerning the partnerships. Finally, it is clear that the total professional fees incurred by each partnership in its first 2 years was very close to the anticipated organization and syndication costs. The only thing that is not clear is what the law firm did in return for the fees it received from the partnerships. Other than Mr. Eisenberg's activities and recitals by Mr. Filler and Mr. Eisenberg of the many services performed by the law firm, most of which appear to duplicate the efforts of actors mentioned above, there is no evidence of activity by the law firm on behalf of the partnerships.

The petitioners' failure to provide any objective evidence concerning the services performed by the law firm for the partnerships is troubling. If any objective evidence exists, such as time sheets, petitioners' counsel, who are members of the law firm, should have produced such evidence. On this record, we cannot determine what services the law firm performed for the partnerships, other than Mr. Eisenberg's activities, and therefore, we cannot allow a deduction for any of the legal services except for those specifically allocated to Mr. Eisenberg.

In his notices of deficiency, the Commissioner made several interest expense adjustments to both Balmoral's and Shelburne's returns. He concedes all such adjustments except those relating to the "bonus payments" by Shelburne to Delta. Such payments were in the amount of 10 percent of all worldwide nontheatrical gross receipts received by the distributor, Paramount. The Commissioner determined that such payments were not deductible because they were not ordinary and necessary business expenses or because the underlying obligation was not a bona fide indebtedness. Mr. and Mrs. Grossman bear the burden of proof on this issue. Rule 142(a).

The source of such interest expense is a loan from Delta to Shelburne with a 9½-percent-per-annum interest rate and the bonus payment provision. The source of such loan was four Netherlands Antilles corporations which loaned the principal amount to CMS at 9-percent interest per annum. Delta, a partnership controlled by CMS, then loaned the funds to Shelburne for one-half percent more and a bonus payment.

A taxpayer may deduct all interest paid or accrued within the taxable year on indebtedness. Sec. 163(a). An indebtedness pursuant to section 163(a) "means an existing, unconditional, and legally enforceable obligation for the payment of money." *Kovtun v. Commissioner*, 54 T.C. 331, 338 (1970), affd. 448 F.2d 1268 (9th Cir. 1971); see *Titcher v. Commissioner*, 57 T.C. 315 (1971). Interest on indebtedness is generally defined to mean "compensation for the use or forbearance of money." *Deputy v. duPont*, 308 U.S. 488, 498 (1940). The real purpose and intention of the parties is controlling and the form of the transaction will be looked through to determine the real character of the payment. *Knetsch v. United States*, 364 U.S. 361 (1960); *Beck v. Commissioner*, 74 T.C. 1534 (1980), affd. 678 F.2d 818 (9th Cir. 1982). Whether the bonus payments were interest payments is a question of fact, the burden of proof of which is on the petitioners. Rule 142(a); *McSorley's, Inc. v. Commissioner*, 323 F.2d 900, 901-902 (10th Cir. 1963).

In his brief, the Commissioner's position is that the bonus payments to Delta were a priority distribution to Delta; he allowed interest deductions for payments relating to the 9½-percent-per-annum payments on the outstanding balance of the principal. Therefore, the underlying debt appears recognizable for tax purposes. To overcome the Commissioner's determination, the petitioners must prove that the bonus payments were compensation associated with such debt.

We conclude that the petitioners have failed to meet their burden of proof. We can find no reasonable linkage between the Delta loan to Shelburne and the bonus payment, other than its use as a mechanism to divert funds from Shelburne to CMS, thereby increasing income to the members of the law firm who participated in both Delta and CMS.

The loan to Shelburne was almost certain to be repaid and, therefore, the bonus payments are not compensation for the use of the funds. The limited partners, all of whom had to be financially secure to participate in Shelburne, were due to make capital contributions in excess of the loan principal. Additionally, the members of the law firm who owned CMS were the same members who owned 50 percent of Capital B, one of Shelburne's general partners. Therefore, if the general partners of CMS were financially secure, the general partners of Shelburne were at least as secure. Finally, the terms of the loan were not negotiated at arm's length; Mr. Filler and Mr. Eisenberg determined the terms of the agreement. In contrast, during the same time period, Paramount received only 8 percent on the nonrecourse notes from FWC, and the four Netherlands Antilles corporations received 9 percent.

Mr. Filler and Mr. Eisenberg testified that the financing was necessary and the terms of the loan were reasonable. They attempted to arrange loans with banks, but the banks were unwilling to make a loan secured by the limited partners' promissory notes for contributions and Shelburne's interest in the four motion pictures. They then determined that 9½-percent interest and the bonus payment would make the loan commercially competitive. Their testimony was not corroborated by objective evidence; no letters concerning such attempts to secure bank financing were presented, and no bank representatives were called to testify.

As a final issue in his brief, the Commissioner argues that this Court erred in quashing the documents portion of his trial subpoenas duces tecum. The Commissioner charges that:

> The Court's actions in refusing to enforce respondent's formal discovery and in quashing virtually all of the documents portions of respondent's trial subpoenas *duces tecum* prevented respondent from fully testing the veracity of witnesses who were directly aligned with and/or controlled by the shelter promoters who, as the evidence has shown, had (and still have) a substantial financial stake in the outcome of this trial. And, as the record shows, respondent's worst fears were realized when various witnesses were put to the test.

The Commissioner's argument is made in a case where there are approximately 900 exhibits, about 10,000 pages in length, and approximately 1,800 pages of transcript, and there were over 1,300 pages in the briefs.

Such subpoenas duces tecum were served on the following individuals, partnerships, and corporations: Messrs. Eisenberg, Filler, Janger, Kanter, Lippitz, and Weiss; FWC; First National Bank of Chicago; Jacobson, Scott & Gordon & Co.; and Paramount. In general, the documents were to be produced on September 10, 1984, 1 week before the trial began and were designed to uncover information the Commissioner failed to get when the Court denied the Commissioner's discovery because the requests were overly burdensome compared to their probative value.

The requests by the Commissioner in such subpoenas duces tecum were usually for all of the documents that involved one or more named individuals or entities from

1977 through 1980 which were in the recipient's possession. However, in some instances, the subpoenas were directed to an entity not directly involved in the central transactions in question, such as CMS or Delta, and requested such entity to produce all of its books and records.

Generally, the Court ordered the recipients of the subpoenas to produce documents which the Commissioner could identify as related to the transactions at issue in the case. However, when the Commissioner merely sought to have the persons subpoenaed produce all of their books and records so that the attorney for the Commissioner could examine them to find out whether they contained any helpful records, and when such person was not a party to the case but was only indirectly involved in some of the transactions, the Court refused to support the subpoena on the ground that the request was too burdensome when weighed against its probative value. See Rule 70(e); Fed. Rules of Civ. P. 26(b); *Carlson Companies, Inc. v. Sperry & Hutchinson Co.*, 374 F. Supp. 1080, 1088-1089 (D. Minn. 1974); *Houdry Process Corp. v. Commonwealth Oil Refining Co.*, 24 F.R.D. 58 (S.D. N.Y. 1959); *Bordonaro Bros. Theatres, Inc. v. Loew's Inc.*, 7 F.R.D. 481 (W.D. N.Y. 1947); *United States v. United States Alkali Export Association*, 7 F.R.D. 256 (S.D.N.Y. 1946). The Court pointed out to the counsel for the Commissioner that he could call those persons as witnesses and that the matter should have been investigated by a revenue agent before the trial.

Despite the fact that at least 500 petitioners have cases related to the case at hand, which concern millions of dollars, and for which notices of deficiency were first issued more than 2 years before trial, the Commissioner had made very little, if any, prior investigation. As a result, his attorney had to attempt through discovery and subpoenas issued by the Court to make the type of investigation that ordinarily would have been carried on by a revenue agent. It is not our position to tell the Commissioner how to carry out his responsibilities, but it is altogether obvious that when cases are brought to court in this manner, much more time is required by the Court and the attorneys to prepare the case for trial and to actually try the case. Had an investigation been made beforehand, many of the minor issues could have been settled; the authenticity of many of the documents could have been agreed upon; and more helpful stipulations could have been made. The processes of this Court are simply not designed to be used to conduct a thorough investigation of a complex tax case.

Decisions will be entered under Rule 155.

LEONE BOSURGI, TRANSFEREE OF THE ESTATE OF ADRIANA BOSURGI, DECEASED, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

EMILIO BOSURGI, TRANSFEREE OF THE ESTATE OF ADRIANA BOSURGI, DECEASED, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 5250-71, 5251-71. Filed December 23, 1986.

R seeks a default judgment against Ps pursuant to Rule 123(a), Tax Court Rules of Practice and Procedure. R alleges that Ps are liable for determined amounts of estate tax and additions to tax as transferees of the assets of an estate. Ps did not appear for their scheduled trial at which time R asked the Court to enter a default judgment. Ps' counsel withdrew as counsel of record in 1976. Ps have not responded to this Court's orders or communicated with this Court. *Held*, entry of a default pursuant to Rule 123(a) is appropriate in these cases. *Held, further*, entry of a default has the effect of Ps' admitting the well-pleaded facts in R's answer, which in the exercise of sound judicial discretion are determined to support a default judgment. *Held, further*, Ps are liable as transferees of the Estate of Adriana Bosurgi.

Leone Bosurgi and Emilio Bosurgi, pro se.
Jack H. Klinghoffer, for the respondent.

OPINION

WILLIAMS, *Judge*:* These cases are before the Court on respondent's motion for default judgment pursuant to Rule 123(a), Tax Court Rules of Practice and Procedure.

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*By order of the Chief Judge, these cases were assigned to Judge Williams for decisions and opinion.

The Commissioner determined a deficiency in the Federal estate tax of the Estate of Adriana Bosurgi, deceased, in the amount of $403,988.78, and an addition to tax pursuant to section 6651(a)(1)[1] of $100,997.20. Respondent asserts that petitioners, sons of Adriana Bosurgi, are liable for the determined amounts of estate tax and addition to tax as transferees of the assets of the estate.[2] The issue this Court must decide is whether to grant respondent's motion for entry of a default against petitioners.

The decedent, Adriana Bosurgi, was an Italian citizen and nonresident alien of the United States. Her sons, Leone and Emilio Bosurgi, were also Italian citizens and nonresident aliens of the United States at the time their petitions in these cases were filed. These cases are the vestige of a long and complex history of litigation.[3] We state only the salient parts of such history below.

On March 2, 1971, the United States made four jeopardy assessments, arising out of the estate tax liability of the Estate of Adriana Bosurgi, against the following: Leone Bosurgi and Emilio Bosurgi, as executors of the Estate of Adriana Bosurgi; Chemical Bank, as statutory executor; and, Leone Bosurgi and Emilio Bosurgi each as transferees of the assets of the estate. On March 3, 1971, the United States filed a complaint in the U.S. District Court for the Southern District of New York against petitioners and Chemical Bank to foreclose certain tax liens of the United States arising out of the estate tax liability of the Estate of Adriana Bosurgi. On June 2, 1972, the District Court entered default judgments against Leone Bosurgi and Emilio Bosurgi, respectively, as transferees of assets of the estate, for their failure to appear, answer, or make any motions with respect to the (amended) complaint of the United States.[4]

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure.

[2] The burden of proof to show that petitioner is liable as a transferee is on respondent. Sec. 6902(a).

[3] In this Court, the litigation involved five cases. In addition to the two cases that are the subject of the motion presently before this Court, the litigation involved (1) the Estate of Adriana Bosurgi, docket No. 5252-71, in which respondent filed motion to dismiss for failure to prosecute properly which was granted on May 21, 1986; (2) Fritzsche Dodge & Olcott, Inc., docket No. 5061-71, in which one of two statutory executors of the Bosurgi estate settled its case, and (3) Chemical Bank, docket No. 4986-71, in which the other statutory executor of the Bosurgi estate settled its case.

The District Court litigation involving claims by Chemical Bank, Fritsche Dodge & Olcott, Inc., and other parties to the litigation continued with respect to assets of the estate held in escrow by Benedict Ginsberg, one of petitioners' former counsel. See *United States v. Bosurgi*, 389 F. Supp. 1088 (S.D. N.Y. 1975), affd. in part, revd. in part, and remanded 530 F.2d 1105 (2d Cir. 1976), on remand 84 F.R.D. 668 (S.D. N.Y. 1979); *United States v. Bosurgi*, 750 F.2d 216 (2d Cir. 1984).

On March 25, 1976, counsel for petitioners in these cases filed a motion to withdraw as counsel of record pursuant to Rule 24(c). Counsel cited as reasons for withdrawal the fact that all attempts at communication with petitioners since July 1971, had gone unanswered. A copy of the motions and an accompanying order directing petitioners to file a notice of objection on or before June 1, 1976, was served on petitioners at "c/o Prof. Avv. Domenico Barillaro, Via Cosseria 1, Rome, Italy," petitioners' last known address. Petitioners did not respond. The Court granted counsel's motion on June 9, 1976.

On December 14, 1985, the Court served petitioners, by registered mail at their last know address, with notices of trial of these cases. The notices of trial were returned to the Court and petitioners did not appear at the call of the calendar of these cases on April 29, 1986. Petitioners did not appear at the trial of these cases on May 8, 1986. The Court has had no communication on behalf of petitioners since the request of their counsel to withdraw.

In his answer to each petition in these cases, respondent pleads the following facts:

> (a) Adriana Bosurgi, an Italian citizen and nonresident alien of the United States, died on March 27, 1963. No estate tax return was filed with respondent.

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[4] The issue of the transferee liability of petitioners was the subject of this related, but separate, proceeding before the District Court for the Southern District of New York during the pendency of this case. Because respondent alleged that the issue litigated in the District Court would dispose of the issue before this Court, trial of this case was continued pending resolution of the District Court litigation.

> (b) Petitioner is a son of the decedent, Adriana Bosurgi, and the brother of Emilio [or Leone] Bosurgi.
>
> (c) On the date of her death, Adriana Bosurgi maintained a custodian account at the Chemical Bank in New York, New York, in which she held securities of an aggregate value of $1,097,189.39.
>
> (d) After Adriana Bosurgi died, the securities held in the custodian account at the Chemical Bank were sold and the proceeds deposited into two separate accounts at the Chemical Bank: a joint checking account in the names of Adriana Bosurgi and/or Leone Bosurgi and/or Emilio Bosurgi; and, in a joint checking account in the names of Leone Bosurgi and/or Emilio Bosurgi. All funds in the former account were subsequently transferred into the latter--that of Leone Bosurgi and/or Emilio Bosurgi.
>
> (e) The aggregate proceeds from the sale of securities in Adriana Bosurgi's custodian account at the Chemical Bank deposited into these joint accounts exceeds the amount of the deficiency in estate tax and addition to tax pursuant to section 6651 determined by respondent.
>
> (f) The transfers described in paragraph (d) above were made to petitioners without consideration.
>
> (g) Respondent assessed the deficiency in estate tax and addition to tax on March 2, 1971 and filed a Federal tax lien on March 2, 1971. No part of the deficiency in estate tax was paid.
>
> (h) By reason of the transfer of assets to petitioners, and their receipt by petitioners, petitioners thereby became transferees of the assets of the estate of Adriana Bosurgi, the decedent, within the meaning of section 6901, and of Section 12.1-1, New York Estates, Powers and Trusts Laws. Further, the transferor, the estate of Adriana Bosurgi, was rendered insolvent by reason of the transfer of assets to petitioners. The insolvency of the transferor precludes reasonable efforts to collect the deficiency in estate tax and addition to tax from the transferor.

Whereupon respondent prayed that the deficiency and addition to tax be in all respects approved, and Leone and Emilio Bosurgi be held liable as transferees of the assets of the Estate of Adriana Bosurgi.

Respondent urges us to enter a default against petitioners pursuant to Rule 123(a). Petitioners failed to appear at the call of the calendar and at the trial of the case, and neither petitioner nor any representative on behalf of either petitioner has responded to this Court's notices or orders for more than 10 years. Respondent cites by analogy rule 55 of the Federal Rules of Civil Procedure (FRCP), from which Rule 123(a) was derived. For the reasons discussed below, we agree that respondent is entitled to entry of a default against petitioner.

Rule 123, effective as of January 1, 1974, provides in relevant part:

> (a) Default: When any party has failed to plead or otherwise proceed as
> ovided by these Rules or as required by the Court, he may be held in
> efault by the Court either on motion of another party or on the
> itiative of the Court. Thereafter, the Court may enter a decision against
> e defaulting party, upon such terms and conditions as the Court may
> eem proper, or may impose such sanctions (see, e.g., Rule 104) as the
> ourt may deem appropriate. The Court may, in its discretion, conduct
> earings to ascertain whether a default has been committed, to determine
> he decision to be entered or the sanctions to be imposed, or to ascertain
> he truth of any matter.

Rule 123(a) is derived from FRCP 55(a) and (b), and there was no counterpart in this Court's Rules prior to the promulgation of Rule 123(a). Rules of Practice and Procedure, 60 T.C. 1057, 1129 (1973).

Under the Federal Rules of Civil Procedure, a default pursuant to FRCP 55 is entered when a defendant fails to plead or otherwise defend as provided by the rules.[5] This rule also applies to any claim, cross-claim, or third-party claim. See FRCP 55(d). Thus, a defendant may be entitled to entry of a default pursuant to FRCP 55(a) on the basis of plaintiff's failure to reply to a counterclaim. See 10 C. Wright, A. Miller & M. Kane, Federal Practice and Procedure, sec. 2682, at 409 (1983). Under the Federal Rules of Civil Procedure, it appears that a "plaintiff" for purposes of FRCP 55(a) may be taken as the party that bears the burden of proof, while a "defendant" within the meaning of FRCP 55(a) is analogous to the opposing party who does not bear the burden of proof.

Rule 123(a) provides, as does FRCP 55(a), that *any* party may move for entry of a default. By analogy to FRCP 55(a), the party that bears the burden of proof is entitled to move for entry of a default pursuant to Rule 123(a).[6]

This Court has been reluctant to enter defaults, notably in cases seeking additions to tax for fraud pursuant to section 6653(b). See *Gilday v. Commissioner*, 62 T.C. 260 (1974); *Doncaster v. Commissioner*, 77 T.C. 334 (1981). However, where the taxpayer stated to the Court that he would not contest the deficiencies or addition to tax for fraud determined by the Commissioner, a default judgment pursuant to Rule 123(a) was entered. *Gordon v. Commissioner*, 73 T.C. 736 (1980). Further, we stated in *Gordon v. Commissioner* that:

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[5] Dismissal pursuant to FRCP 41(b), from which Rule 123(b) is derived, is appropriate when a plaintiff fails to prosecute or to comply with the rules. Rule 123(b) is this Court's counterpart to FRCP 41(b).

[6] By analogy to Rule 41(b), the party that does not bear the burden of proof may move for dismissal pursuant to Rule 123(b). Dismissals pursuant to Rule 123(b) are commonly made in this Court, while this case is the first reported opinion in which a decision will be entered pursuant to a default under Rule 123(a) solely on the basis of well pleaded facts.

> It may be arguable that our recently adopted default provisions in Rule 123(a), as well as the development of the Federal case law under rule 55, Federal Rules of Civil Procedure (enacted subsequent to *Miller-Pocahontas [Coal Co. v. Commissioner*, 21 B.T.A. 1360 (1931)]),would justify the exercise of our discretion in permitting a default to include a fraud addition to tax without affirmative proof in the case of mere nonappearance at the trial. [73 T.C. at 742; fn. ref. omitted.]

We should, however, reiterate that this case does not present a fraud issue. Consequently, the question of the vitality of *Miller-Pocahontas Coal Co. v. Commissioner*, 21 B.T.A. 1360 (1931), is not before us, and no inference should be drawn as to the effect of this opinion on similar cases that do present a fraud issue. This is not the occasion for overruling or for reaffirming *Miller-Pocahontas*.

Faced with a mountainous work load, this Court should not suffer the continued waste of its time and of the Government's resources in the litigation of cases brought by taxpayers who have no demonstrable desire to continue the litigation. If a taxpayer does not think well enough of his case to defend it where the Government has the burden of proof, this Court should default him. To hold a trial in a case abandoned by the taxpayer is at best an indulgence of archaic manners and at worst an insult to the taxpayers who have a rightful claim on this Court's time. The time has come, at least in transferee liability cases, to declare that we will no longer engage in "one-act pantomimes." See concurring opinion of Judge Wilbur in *Doncaster v. Commissioner*, 77 T.C. at 345 (1981). Entry of a default judgment is appropriate upon a determination in the sound judicial discretion of the Court that the pleadings of the moving party set forth facts sufficient to support the judgment.[7]

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[7] A number of factors must be considered by the Court in the exercise of its discretion. See 10 C. Wright, A. Miller & M. Kane, Federal Practice and Procedure, sec. 2685, at 423-429 (1983).

Entry of a default has the effect of admitting all well-pleaded facts in respondent's answer, and a default judgment must be supported by respondent's well-pleaded facts. *Trans World Airlines v. Hughes*, 449 F.2d 51, 70 (2d Cir. 1971), revd. on other grounds 409 U.S. 363 (1973); *Rechtzigel v. Commissioner*, 79 T.C. 132, 142 (1982), affd. 703 F.2d 1063 (8th Cir. 1983). A default judgment is a judgment on the merits. *Nishimatsu Construction Co., Ltd. v. Houston National Bank*, 515 F.2d 1200, 1206 (5th Cir. 1975).

Section 6901(a) provides a procedure under which unpaid estate tax of the transferor may be assessed against and collected from the transferee. However, the existence and extent of a transferee's liability is governed by State law.[8] *Commissioner v. Stern*, 357 U.S. 39 (1958); *Scott v. Commissioner*, 70 T.C. 71 (1978). Because the property transferred to petitioners was located in New York at the date of the death of the decedent, respondent's well-pleaded facts must establish petitioners' liability as transferees pursuant to the laws of the State.

The facts pleaded by respondent establish that Adriana Bosurgi, the decedent, owned certain assets which were part of her estate and which were received by petitioners, the decedent's sons, and distributees, subsequent to her death. The value of the assets received by petitioners is greater than the amount of the deficiency in Federal estate tax and addition to tax determined by respondent. The Estate of Adriana Bosurgi was rendered insolvent as a result of the transfer of its assets to the account of petitioners. The existence and extent of petitioners' liability for Federal estate tax as a distributee of the assets of the Estate of Adriana Bosurgi under the laws of the State of New York are established. See 13 N.Y. Dec. Est. Law Ann. sec. 170 (McKinney Supp. 1967); see also N.Y. Est. Powers & Trusts Law sec. 12-1.1 (McKinney 1967), effective Sept. 1, 1967.

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[8] Sec. 6324(a)(2) provides for the substantive liability of transferees of the assets of an estate for Federal estate tax due, without regard to State law. Groetzinger v. Commissioner, 69 T.C. 309, 316 (1977); see also *Schuster v. Commissioner*, 312 F.2d 311 (9th Cir. 1962), affg. 32 T.C. 998 (1959). However, sec. 6324(a) applies only to transferees who have received property included in the gross estate pursuant to secs. 2034 through 2042. Here, the transfer of the assets of the estate occurred after the date of death of the decedent. The property was not included in the gross estate of Adriana Bosurgi by reason of secs. 2034 through 2042, but by reason of sec. 2033. Therefore, sec. 6324(a)(2) does not apply.

Therefore, pursuant to section 6901, petitioners are liable as transferees of the assets of the Estate of Adriana Bosurgi for the full amount of the deficiency in Federal estate tax and addition to tax determined by respondent.

To reflect the foregoing,

An appropriate order and decision will be entered.

Reviewed by the Court.

STERRETT, SIMPSON, NIMS, PARKER, KÖRNER, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, GERBER, WRIGHT and WELLS, *JJ.*, agree with the majority opinion.

WHITAKER and SHIELDS, *JJ.*, did not participate in the consideration of this case.

PARR, *J.*, dissenting: I respectfully dissent. The majority opinion runs counter to a long line of analogous cases going back to 1931. See *Miller-Pocahontas Coal Co. v. Commissioner*, 21 B.T.A. 1360 (1931). Such a drastic change is not required to deal with the problem posed by a petitioner who has failed to answer his mail or to appear at trial, where, as here, Congress has imposed on respondent the burden of proof. Sec. 6902(a); Rule 142(d). The current rules of this Court already afford respondent a wide range of procedures for obtaining judgment in his favor if he wishes to avoid putting on his case.

Rule 37(c) provides one simple and quick remedy. Where petitioner does not file a reply to respondent's affirmative allegations, such allegations are generally deemed denied. However, respondent has 45 days to move that specified allegations in the answer be deemed admitted. That motion may be granted unless the required reply is filed within the time directed by the Court. Respondent can use the admitted allegations to meet his burden of proof. See *Gilday v. Commissioner*, 62 T.C. 260 (1974).

Here, however, petitioner filed a reply denying respondent's affirmative allegations.

Where Rule 37(c) is of no help to respondent, as in this case, he can look to Rule 90. A request for admissions may be served at any time between 31 days after joinder of issue and 75 days before the date set for call of the case from a trial calendar. Under Rule 90(c) each matter is deemed admitted unless, within 30 days after service, petitioner denies, asserts reasons why he cannot admit or deny, or objects. A petitioner's deemed admissions may thus provide a valid basis for finding respondent's burden has been met, and the case can be decided on respondent's motion for summary judgment. *Doncaster v. Commissioner*, 77 T.C. 334 (1981).

After a trial notice is issued, and up to 45 days before the trial calendar, respondent can invoke Rule 91(f) and move to compel stipulation. This is more cumbersome than a request for admissions and requires the involvement of the Court. Nevertheless, it is a relatively simple procedure where petitioner refuses to respond. We may enter an order deeming facts admitted. Again, such facts can then form the basis for a decision for respondent.

If respondent has failed to timely pursue any of these remedies, he can put on his proof in a one-sided trial. I do not regard such a trial as "an indulgence of archaic manners" or a "one-act pantomime." This Court has often declined to find for respondent solely on the ground that respondent has not met his burden of proof. Bare allegations by respondent, however well pleaded, are not competent evidence. Respondent should not be allowed to ignore the rules and then seek a default judgment as a substitute for preparing his case.

I share Judge Williams' concern for the enormous backlog that plagues the Court, as well as his frustration with petitioners who waste our time. However, I believe the answer lies in encouraging respondent to use the tools we have provided to meet his burden, rather than allowing him to escape that burden entirely.

CHABOT, *J.*, agrees with this dissent.

JOHN ALBERT MICHAELS AND REBECCA HOOPER MICHAELS, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 39917-85. Filed December 23, 1986.

When petitioners sold their residence, they made the sale contingent upon receiving a discount from the mortgagor upon the prepayment of their recourse mortgage. They subsequently purchased a new residence costing more than the one sold. Petitioners included the discount in the gain realized on the sale, but deferred recognition of the gain under sec. 1034, I.R.C. 1954. Respondent determined that the discount should be taxed separately as income from discharge of indebtedness under sec. 61(a)(12). *Held*: A discount received on the prepayment of a recourse mortgage made in connection with the sale of a residence is not included in the "amount realized" for purposes of computing gain on the sale. Consequently, it is reportable separately as discharge of indebtedness income.

John Albert Michaels, pro se.

Edwina L. Charlemagne, and *Deborah L. Hildebran* for the respondent.

STERRETT, *Chief Judge*: The parties' cross-motions for summary judgment filed herein were assigned to Special Trial Judge Joan Seitz Pate pursuant to the provisions of section 7456(d) (redesignated as sec. 7443A(b) by the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2755), and Rules 180 and 181.[1] After a review of the record, we agree with and adopt the opinion of the Special Trial Judge which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

PATE, *Special Trial Judge*: This case is before the Court on the parties' cross-motions for summary judgment under Rule 121. Respondent determined a deficiency in petitioners' 1982 Federal income tax of $1,293. The issues for our decision are (1) whether petitioners must recognize as income a discount allowed on the prepayment of a first mortgage made in connection with the sale of their residence, and (2) if so, whether the discount is to be taxed as ordinary income or long-term capital gain.

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[1] Unless otherwise stated, all section references are to the Internal Revenue Code of 1954 as amended, and all rule references are to the Tax Court Rules of Practice and Procedure.

The parties have either agreed to or conceded, for purposes of our ruling on their motions, the following facts. John Albert Michaels and Rebecca Hooper Michaels (hereinafter petitioners) are husband and wife and filed a joint income tax return for 1982. They resided in Raleigh, North Carolina, at the time their petition was filed.

In March 1978, petitioners purchased a residence for $36,639, including closing costs. The property was encumbered by a mortgage payable to Perpetual Federal Building & Loan of Anderson, South Carolina (hereinafter Perpetual). Petitioners sold this home in 1982 when they moved to Raleigh, North Carolina. The sale took place on June 30, 1982, for a stated sales price of $40,000.

In addition, the contract of sale specifically provided that the "Sale [was] contingent upon Seller receiving 25% discount on mortgage balance at Perpetual." Consequently, at settlement, petitioners' first mortgage loan was prepaid for an amount $6,378 less than the then principal balance of the loan. All of the benefit of this discount accrued to petitioners. In February 1983, petitioners purchased a new residence for $65,000.

Petitioners did not report this discount as income on their 1982 Federal income tax return. Instead, they included the discount as part of the gain on the sale of their residence, all of which they deferred pursuant to the provisions of section 1034. The parties have agreed that petitioners meet all of the requirements of section 1034 and are subject to its provisions. The only disagreement arises in the computation of the gain. Petitioners contend that the benefit they received from the discount is an integral part of the sales transaction and therefore is part of the gain realized but not recognized under section 1034. Respondent maintains that the discount Perpetual awarded cannot be taken into account in computing petitioners' gain under section 1034, but instead, must be taxed separately as income from discharge of indebtedness under section 61(a)(12). Moreover, respondent maintains that such discount must be taxed as ordinary income.

Generally, funds a taxpayer borrows are not includable in his gross income, even though they increase his assets, because the taxpayer has a corresponding liability to repay the loan. See *United States v. Rochelle*, 384 F.2d 748, 751 (5th Cir. 1967), cert. denied 390 U.S. 946 (1968); *Carolina, Clinchfield & Ohio Railway Co. v. Commissioner*, 82 T.C. 888, 896 (1984). Consequently, if a taxpayer pays off a debt at less than its face amount, the canceled portion constitutes income because it makes available assets previously offset by liabilities. Sec. 61(a)(12); sec. 1.61-12(a), Income Tax Regs.; *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). Therefore, unless a statutory or judicial exception excludes the discount from income, the amount of the discount is included as discharge of indebtedness income in the year the debt is canceled. *Montgomery v. Commissioner*, 65 T.C. 511, 520 (1975). See sec. 1.61-12(e), Income Tax Regs. See also *Colonial Savings Association v. Commissioner*, 85 T.C. 855, 861-863 (1985).

Petitioners do not dispute these general rules, but rather contend that they do not apply in the instant case. They reason that because: they sold their residence during 1982; the prepayment of their mortgage was a consequence of that sale; and the buyer's funds were used for the prepayment; the resulting discount should be taken into account in computing the gain realized but not recognized under the provisions of section 1034.

In general, section 1034 requires that a taxpayer defer recognition of gain on the sale of a principal residence when the adjusted sales price of the residence sold is less than the cost of a new residence. The provisions of section 1034 affect only the amount of gain recognized in the year the residence is sold. The total gain realized is determined under the provisions of section 1001 and the regulations issued thereunder. Sec. 1.1034-1(a), Income Tax Regs.

Looking to section 1001, we find that gain from the sale of property is computed by subtracting from the "amount realized" on the sale the adjusted basis of the property. Secs. 1001(a), 1011. Section 1001(b) defines the term "amount realized" as the sum of any money plus the fair market value of other property received as a result of the sale. As a general rule, when a transferor is discharged from liability in connection with a sales transaction, the entire urrent balance of such liability is included in the amount alized. Sec. 1.1001-2(a)(1), Income Tax Regs.; *Commisioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner*, 31 U.S. 1 (1947).

However, section 1.1001-2(a)(2), Income Tax Regs., proides an exception for *recourse* liabilities.[2] It states that—

> he amount realized on a sale or other disposition of property that cures a recourse liability does not include amounts that are (or would if realized and recognized) income from the discharge of indebtedness nder section 61(a)(12).] * * * [3]

This regulation effectively bifurcates the instant transacon by removing the amount of the discount from the omputation of the amount realized and recognizing it as a parate income item. Therefore, although the prepayment f petitioners' mortgage was an integral part of the sale, e regulation treats it as a separate transaction for tax urposes.[4]

The term "amount realized" is also defined in section 1034-1(b)(4), Income Tax Regs., which states that—

> (4) "Amount realized" is to be computed by subtracting
>
> (i) The amount of the items which, in determining the gain from the le of the old residence, are properly an offset against the considerations ceived upon the sale (such as commissions and expenses of advertising e property for sale, of preparing the deed, and of other legal services in nnection with the sale); from
>
> (ii) *The amount of the consideration so received, determined (in cordance with section 1001(b) and regulations issued thereunder)* by ding to the sum of any money so received, the fair market value of the operty (other than money) so received. *If, as part of the consideration r the sale, the purchaser either assumes a liability of the taxpayer or*

The record is silent as to whether petitioners' first mortgage was, in fact, a recourse or nrecourse liability. However, this fact is presumed to be the basis of respondent's termination, and petitioner has not contended otherwise. See *Ewart v. Commissioner*, 85 C. 544, 547-548 (1985), on appeal (6th Cir., Jan. 8, 1986); *Jarvis v. Commissioner*, 78 T.C. 6, 658 (1982); Rule 34(b)(4).

The regulation then refers to sec. 108 and sec. 1.61-12(b)(1), Income Tax Regs., for uations where amounts arising from the discharge of indebtedness are not realized and cognized. We have examined the provisions of those sections and find that they are not evant to our determination of "amount realized" under the facts of this case.

The bifurcated approach was adopted in analyzing a transaction involving discharge of lebtedness income in *Vukasovitch, Inc. v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986), g. T.C. Memo. 1984-611. For a review of the background of this approach, see Cunningham, ayment of Debt with Property - The Two Step Analysis after *Commissioner v. Tufts*," 38 x Law. 575 (Spring 1985).

> *acquires the old residence subject to a liability (whether or not the taxpayer is personally liable on the debt), such assumption or acquisition, in the amount of the liability, shall be treated as money received by the taxpayer in computing the "amount realized."*
>
> [Emphasis supplied.]

In this regulation, the term "amount realized" has a slightly different meaning. First, for purposes of computing "gain realized" (defined in sec. 1.1034-1(b)(5), Income Tax Regs.), it allows the deduction of selling expenses (as defined in section 1.1034-1(b)(4)(i)), therefore making the term "amount of the consideration" in this regulation the equivalent of "amount realized" under section 1001(b).

Second, this regulation provides that "the [entire] amount of liability" shall be included in computing the amount of the consideration when the buyer assumes the liability of the seller or acquires the property subject to the liability. Consequently, under those circumstances, the transaction is not bifurcated even if, immediately thereafter, the buyer pays off the liability on the purchased property. However, this scenario is distinguishable from the instant transaction because (1) the buyer would receive the benefit of the discount instead of the seller, and (2) the buyer would have to recognize discharge of indebtedness income when he prepaid the liability. It appears, therefore, that in a sales transaction under section 1034 involving a discount on the prepayment of a recourse mortgage, the buyer and seller can determine which of them must recognize the discharge of indebtedness income, but cannot convert the discount into gain realized on the sale of the residence.

Our finding that the discount on the prepayment of the mortgage is not part of the amount realized on the sale is also determinative of the second issue before us. Income taxed under the capital gain provisions must result from the "sale or exchange" of a "capital asset." *National-Standard Co. v. Commissioner*, 749 F.2d 369, 370 (6th Cir. 1984), affg. 80 T.C. 551 (1983). By bifurcating the transaction, the regulations require that we view the prepayment of the mortgage separately from the sale. It is well settled that the payment of an obligation is not a "sale or exchange" for tax purposes. *Fairbanks v. United States*, 306 U.S. 436, 437 (1939); *Osenbach v. Commissioner*, 198

F.2d 235, 236-237 (4th Cir. 1952), affg. 17 T.C. 797 (1951). Therefore, since the discount here at issue was realized by the prepayment, which is not considered a sale or exchange, no capital gain can result.

Alternatively, petitioners argue that the discount reduces their basis in their residence, thereby increasing gain realized. Section 108 allows a taxpayer to exclude discharge of indebtedness income and reduce the basis of assets under certain circumstances. However, we have carefully examined the provisions of section 108 and have found nothing even arguably applicable to the facts in this case. Therefore, we find it unnecessary to discuss its lengthy provisions here.

Petitioners do not point to any other statutory or judicial exception supporting their argument.[5] They do argue, however, that Congress intended section 1034 to defer recognition of the gain on the sale of residences when taxpayers reinvest the proceeds from the sale of their homes in higher priced homes and that respondent's position defeats this objective.[6] While there is some force to this argument, we cannot afford petitioners relief without clear statutory authority for this proposition, as we are bound by the wording of the statute as enacted and the accompanying regulations, when consistent therewith.

Accordingly,

An appropriate order and decision will be entered.

ILLINOIS POWER COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 28136-84. Filed December 23, 1986.

P incorporated IPFC and in form: (1) Gave 50 percent of IPFC's stock to MU; and (2) sold nuclear fuel to IPFC who simultaneously leased the fuel back to P (the "sale-leaseback"). *Held*:

1. P may not disavow the form of the transfer of stock to MU, but may disavow the form of the sale-leaseback.

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[5] But see *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934).

[6] See H. Rept. 586, 82d Cong., 1st Sess. (1951), 1951-2 C.B. 357, 377.

***Comdisco, Inc. v. United States*, 756 F.2d 569 (7th Cir. 1985), followed.**

2. The sale-leaseback constituted a financing for Federal tax purposes, with the result that P is not required to recognize gain on the "sale" of the fuel.

3. P may deduct its liability for "lease" charges for 1980.

4. P did not receive interest income in connection with the purported transfer of the nuclear fuel.

Edward C. Rustigan and *William A. Schmalzl*, for the petitioner.

Matthew J. Fritz, for the respondent.

KÖRNER, *Judge*: Respondent determined a Federal income tax deficiency against petitioner for the taxable year ended December 31, 1981, in the amount of $4,543,330.80.

After concessions, the issues remaining for decision are: (1) Whether petitioner's transfer of 50 percent of the common stock of Illinois Power Fuel Co. to Millikin University on February 2, 1981, should be disregarded so that Illinois Power Fuel Co. is considered a member of its "affiliated group" for purposes of petitioner's consolidated return; (2) whether a transfer of nuclear fuel by petitioner to Illinois Power Fuel Co. on February 2, 1981, which was cast as a sale-leaseback was in reality a financing arrangement for Federal tax purposes; (3) whether petitioner is entitled to deduct the liability it accrued for lease charges in connection with the transfer of the nuclear fuel; and (4) whether petitioner received interest income in connection with the transfer of the nuclear fuel.[1]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

General Background

Petitioner is an Illinois corporation with its principal office at Monticello, Illinois, and its executive office at Decatur, Illinois. For the taxable year ended December 31,

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[1] At trial herein, an unrelated issue was severed and will be disposed of by further proceedings after the present issues are decided.

l1, petitioner filed a U.S. Corporation Income Tax Return
rm 1120) using the accrual method of accounting.

Petitioner has been, at all times herein pertinent, a public
lity subject to regulations of the Illinois Commerce
mmission (ICC) and the Federal Energy Regulatory Com-
ssion (FERC). During the year in issue, petitioner was
gaged in the manufacture and sale of electric power to
eas in central and southern Illinois.

During 1981, petitioner owned an 80-percent undivided
erest in a nuclear power plant (known as the Clinton
wer Station) presently under construction near Clinton,
inois. The remaining ownership was held by Western
inois Power Cooperative and Soyland Power Cooperative.

Construction of the Clinton Power Station began with site
eparation in 1975. Heavy construction commenced in
76. Petitioner's total investment in the Clinton Power
ation is expected to exceed $2.7 billion. The cost of the
tial core of nuclear fuel for the Clinton Power Station is
proximately $125 million.

Nuclear fuel is a custom made product that can only be
ed in the plant for which it was designed. The process of
taining nuclear fuel by a utility requires the acquisition of
v uranium, the enrichment of the uranium, and the
rication of fuel assemblies. Prior to 1981, petitioner had
tered into contracts with Kerr-McGee Nuclear Corp. for
e purchase of raw uranium, with the U.S. Government
rough the Atomic Energy Commission, the Energy Re-
arch and Development Administration, or the Department
Energy) for uranium enrichment services, and with
neral Electric Co. for fuel fabrication services for the
clear fuel to be used at the Clinton Power Station. Prior
February 2, 1981, petitioner made prepayments on these
ntracts totaling approximately $34 million.

Petitioner typically maintains a capital structure of 45-
rcent debt, 12-percent preferred stock, and 43-percent
nmon stock. Debt financing is the least expensive form
capital for utilities and common stock is the most
pensive, because of the differing risks to investors.[2]

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n other words, because any return on common stock may only be paid after interest
gations on debt, the common stockholder has more risk than the debt holder, and
equently, requires a higher rate of return.

When raising additional funds petitioner attempted to maintain the above capital structure, as the issuance of debt without also issuing additional equity results in a decline in petitioner's credit rating, thus increasing the cost of borrowing. Petitioner initially financed the above prepayments for nuclear fuel under its normal capital structure, by using a mixture of debt and common and preferred stock. Subsequently, petitioner decided to explore other options for financing the nuclear fuel which would avoid putting pressure on its credit rating, and would also lower the financing cost of the fuel.

The Sale-Leaseback

On the advice of its investment bankers, petitioner decided to finance the nuclear fuel supplied to the Clinton Power Station through the form of a sale-leaseback transaction, the terms of which are set forth below. In pursuit of this objective, on January 2, 1981, petitioner formed a corporation known as Illinois Power Fuel Co. (IPFC) with a capitalization of $100,000. On that same date, 100,000 shares of IPFC's stock were issued to petitioner. All of the officers and directors of IPFC are and always have been officers of petitioner. IPFC has no employees.

(a) *Approval by the FERC and the ICC*

On November 7, 1980, petitioner filed with the FERC an "Application for Determination of Lack of Jurisdiction or Application for Authorization to Enter Into a Lease for Nuclear Fuel and a Cash Deficiency Agreement." In the application, petitioner represented, inter alia, that as part of the lease agreement petitioner would incorporate a subsidiary (i.e., IPFC) in which petitioner would retain a 50-percent equity interest with the remaining 50-percent to "be donated by the company to a tax exempt charitable institution or sold to an independent entity."

Petitioner also represented that it would sell nuclear fuel to IPFC, lease the fuel back from IPFC, and enter into a "Cash Deficiency Agreement." Under the Cash Deficiency Agreement (see *infra*), petitioner was obligated to make loans to IPFC at any time the obligations of IPFC which were due, exceeded the funds available to IPFC. Petitioner was also obligated to maintain bank lines of credit to support its own and IPFC's commercial paper.

Petitioner contended in the application that the above-described transaction did not fall within the scope of section 204 of the Federal Power Act, 16 U.S.C. sec. 824c (1982), which requires FERC approval of transactions involving (1) the issuance of a security or (2) the assumption of an obligation or liability as a guarantor, endorser, surety, or otherwise, in respect of the security of another person. Petitioner claimed that it did not assume any obligation or liability as a guarantor, endorser, surety, or otherwise in respect of any security of IPFC.

In its opinion, the FERC first noted that under the terms of the Cash Deficiency Agreement, petitioner was absolutely bound to the repayment of securities (i.e., the commercial paper) of IPFC, in the event of a default by IPFC, and that therefore, the proposed transaction constituted the assumption of an obligation or liability in respect of a security within the purview of section 204 of the Federal Power Act. Nevertheless, the FERC found that the transaction was consistent with the provisions of section 204 of the Federal Power Act, and thus, on December 18, 1980, it entered an order authorizing petitioner to enter into the arrangement.

On October 15, 1980, petitioner filed with the ICC a petition seeking authority to make an investment in, to transfer certain assets to, and to enter into and perform certain agreements with, IPFC. In this petition, petitioner represented that it intended to enter essentially the same transaction as was previously described with reference to the FERC. On December 23, 1980, the transaction was approved by the ICC.

(b) *The Transfer of Stock by Petitioner to Millikin University.*

As is indicated above, both the FERC and ICC approved the formation of IPFC and donation of 50-percent of the IPFC stock to a charitable organization. On February 2, 1981, petitioner transferred 50,000 shares of IPFC's stock to Aston & Co., a nominee of Millikin University. Also on that date, petitioner and Millikin University executed a document entitled "Stock Transfer Restrictions and Stock Purchase Agreement." This agreement prohibits Millikin University from transferring its stock without providing petitioner with written notice. It also provides, inter alia, that within 90 days of such notice, petitioner shall either: (1) Consent to the transfer; (2) designate a recipient for a gift of the shares proposed to be transferred; or (3) purchase the shares at book value. In the event of a deadlock in any action of the shareholders or of the board of directors of IPFC, or at the termination of the Lease Agreement (see *infra*), the agreement provides that petitioner may designate a recipient for a gift of or purchase any or all of the IPFC shares.

On its Form 1120, U.S. Corporation Income Tax Return for 1981, petitioner reported a charitable contribution deduction of $50,000 in connection with the transfer of the 50,000 shares of IPFC stock to Millikin University.[3] It also reported in the Affiliations Schedule attached to the return, that its ownership in IPFC decreased to 50 percent on February 2, 1981, and left blank the space provided for disclosing that equitable ownership of the stock differed from record ownership of the stock. In its annual report to the FERC for 1981, petitioner reported a miscellaneous income tax deduction for the "Donation of IP Fuel Company Stock" in the amount of $50,000. On Schedule H of its 1981 Corporate Income Tax Return (Form 1120) IPFC reported that it was 50-percent owned by Millikin University.

Millikin University has never been involved in the management or operation of IPFC, but instead it has always authorized petitioner to vote its shares. It has also received a dividend from IPFC during each of the years it has held the stock.

(c) *The Terms of the Sale-Leaseback*

On February 2, 1981, petitioner and IPFC executed documents entitled: (1) Bill of Sale to Illinois Power Fuel Co. (the Bill of Sale); (2) Nuclear Fuel Lease Agreement (the

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[3] It appears that Millikin University is a sec. 501(c)(3), I.R.C. 1954, organization to which deductible donations may be made under the provisions of sec. 170, I.R.C. 1954; neither party contends otherwise.

Lease Agreement); and (3) Cash Deficiency Agreement (collectively referred to as the Nuclear Fuel Agreements). The Bill of Sale provides, in part, that:

> for and in consideration of the sum of $39,810,165.19 * * * the Vendor [petitioner] hereby conveys, transfers, sells, assigns and sets over all of the personal property consisting of the bundles of nuclear fuel, the components thereof, other nuclear material or interest therein and/or interests in contracts described in Exhibit I hereto (the "Nuclear Fuel"), and by this bill of sale does hereby grant, bargain, transfer, sell, assign and deliver the Nuclear Fuel unto the Purchaser [IPFC] to have and to hold the Nuclear Fuel unto itself, its successors and assigns, forever.

The $39,810,165.19 purchase price represents the amount at which petitioner carried the fuel on its books (payments on fuel contracts plus the accrual of interest during the construction of the project). The Bill of Sale also provides that IPFC was licensed to own, but not to possess the nuclear fuel, and that possession of the fuel would be with petitioner or a manufacturer. The document further provides that "under no circumstances shall a transfer of possession of the Nuclear Fuel to the Purchaser be necessary for the transfer of ownership effected and intended to be effected by this Bill of Sale."

Pursuant to the Lease Agreement, IPFC leased the nuclear fuel which was the subject of the Bill of Sale back to petitioner. Under the agreement, petitioner as lessee is obligated to make payments to IPFC as lessor, consisting of "Basic Rent" and "Additional Rent." Basic Rent is defined as "the sum of the Monthly Lease Charge, less the Capitalized Monthly Lease Charges, plus the Burn-up Charge for the preceding month." The Monthly Lease Charge is essentially all of the borrowing costs or other costs incurred by IPFC during a particular month.[4] The

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[4] The Monthly Lease Charge is defined for any calendar month during the term of the lease as:

(i) an accrual for such month of all interest expense, and of the amortization of debt discount, whether or not paid, with respect to all indebtedness of Lessor for borrowed money which is outstanding at any time during such month; plus

(ii) an accrual for such month with respect to all commitment and other fees, costs and expenses (including depositary's or issuing agent's fees, Commercial Paper, support fees, dealer fees and debt placement fees) and similar expenses incurred by Lessor in connection with its borrowings of money; plus

(iii) an accrual for such month of a management charge composed of:

(a) The cost recovery for a prorata [sic] portion of all of Lessor's operating expenses (other than those, if any, included in preceding clauses (i) and (ii)) for the calendar year in which such

Capitalized Monthly Lease Charges are defined as "Monthly Lease Charges included in the Capitalized Cost of Nuclear Fuel." "Capitalized Cost" is in turn defined to include any portion of the Monthly Lease Charges for which petitioner has elected to defer payment.[5] The Burnup Charges are computed by first calculating the Net Investment Value[6] of the fuel, and then multiplying this amount by a fraction consisting of the number of units of heat consumed during a month over the total number of units of heat in the reactor.

Additional Rent is defined to include essentially any other administrative or interest expenses incurred by IPFC not paid as part of Basic Rent.

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month occurs, as projected by Lessor and provided to and reviewed by Lessee before the beginning of such year (or before the beginning of the term of the Lease in the case of the calendar year in which such term begins), adjusted annually for the difference between Lessor's projected management charge and the amount of such expenses actually incurred for the preceding calendar year; plus

(b) An allowance equal to one-twelfth of that amount which produces the same annual rate of return on Lessor's total common equity at the beginning of such month (being, for this purpose, the total of the capital received by Lessor for its outstanding common stock plus any capital contributed to Lessor and allocable to such common stock) as the common equity rate of return which was used to determine the retail electric rates in effect for Lessee in the State of Illinois at the end of such month; and minus

(iv) Lessor's cash income for such month on investment of moneys received in connection with the transactions contemplated by the Lease or any Credit Agreement, other than moneys received pursuant to clause (iii) above. Any figure used in the computation of any component of the Monthly Lease Charge shall be stated with sufficient accuracy to enable calculation of the Monthly Lease Charge to the nearest dollar. No accrual, charge or other item which would constitute a part of the Acquisition Cost shall be included in the computation of Monthly Lease Charges.

[5] The Lease Agreement provides:

"Capitalized Cost means the sum of * * * (iii) if and to the extent that Lessee elected to capitalize any such Monthly Lease Charges, Monthly Lease Charges accrued pursuant to the Lease which, in Lessee's sole judgment, are allocable to such Nuclear Fuel (a) during any stage of its Nuclear Fuel Cycle other than Heat Production or (b) during the period beginning on the Termination Notice Date and ending on the Termination Settlement Date; provided, however, that Monthly Lease Charges may be allocated to and included in Capitalized Cost by Lessee in an amount not exceeding the sum of (x) the amount of credit then immediately available to Lessor under any Credit Agreement plus (y) any cash available to Lessor for the purpose of paying such Capitalized Monthly Lease Charges in any account under any Credit Agreement."

[6] The Net Investment Value (N.I.V.) of the fuel is equal to "the excess of the amount of the Investment in such [fuel] over the aggregate amount of Burn-up Charges theretofore paid by Lessee to Lessor ." The accrued liability for the Monthly Lease Charge becomes part of the N.I.V. through the definition of "Investment" which includes all Capitalized Costs:

"Investment" means with respect to any portion of the Nuclear Fuel, the sum of (i) the Acquisition Cost for such portion, plus (ii) the Capitalized Cost for such portion, which has been paid or accrued by the Lessor, including payments by Lessor to Lessee.

When current payment of the Monthly Lease Charge is deferred by treating such payments as Monthly Lease Charges, such amounts become part of Capitalized Costs. Thus, any liabilities for interest under the Monthly Lease Charge for which petitioner has elected to defer payment become part of the N.I.V. used in computing the Burnup Charge.

The Lease Agreement terminates on December 31, 2021, unless either party elects with 12-months notice to terminate the lease on an earlier date. The expected life of the nuclear fuel is approximately 3 to 4 years.

Once the nuclear fuel is loaded into the reactor it cannot be used elsewhere and will be converted into nuclear waste that has no residual value. The spent fuel must then be disposed of to avoid contamination. To insure that petitioner is responsible for the cost of this disposition, title to the nuclear fuel reverts to petitioner upon the earlier of removal of the nuclear fuel from the reactor or termination of the Lease Agreement. Petitioner is not required to make any payments to regain title unless payments during the term of the Lease Agreement have been insufficient to cover all of IPFC's obligations.

As IPFC had a capitalization of only $100,000, it had to issue commercial paper to obtain funds necessary to acquire the nuclear fuel. Although the commercial paper is issued solely in the name of IPFC, to ensure that purchasers of IPFC commercial paper would be repaid, IPFC and petitioner executed the Cash Deficiency Agreement. The agreement defines "cash deficiency" as:

> With respect to any Due Date, the amount by which the aggregate of the Indebtedness of [IPFC], due and payable on such Due Date, exceeds the amount of money then available to [IPFC] for payment thereof.

"Due Date" is defined as:

> Any date on which any Indebtedness of [IPFC] is due and payable, provided that in the case of Indebtedness which by contractual or statutory provisions is due and payable within a period of time, the Due Date for such Indebtedness shall be the last day on which such payment may be made without violating the contractually or statutorily prescribed time limit for payment and without incurring any additional charge (however denominated) or other penalty on account of late payment.

The agreement further provides:

> Section 2. *Borrowings to pay cash deficiencies.*
> (a) *Borrowing*
> If for any reason whatsoever [IPFC] has a Cash Deficiency on any Due Date. [Petitioner], upon demand by [IPFC], shall forthwith pay to [IPFC] in lawful money of the United States of America, an amount equal to such Cash Deficiency. Each amount so paid by [petitioner] shall constitute a borrowing from [petitioner] by [IPFC], bearing interest at the

rate determined in accordance with Exhibit A to this Agreement. The principal amount of each such borrowing, together with the interest accrued thereon, shall be due and payable to the order of [petitioner] at [petitioner's] principal place of business or at such other place as may have been specified in a notice given by [petitioner] to [IPFC], on or before the ninetieth day after the date the particular borrowing was made. The Indebtedness of [IPFC] on account of its borrowings pursuant to this Section shall be subject to the subordination provisions in Section 5 hereof and is herein sometimes called "Subordinated Debt."

* * * * * * *

Section 3. *[Petitioner] to Maintain Lines of Credit.*

During the term of this Agreement, [petitioner] shall maintain unused lines of credit with lending institutions under which [petitioner] shall be entitled to borrow sums of money in an aggregate amount equal to the total of (a) the aggregate principal amount of the Commercial Paper of [IPFC] then outstanding (b) plus the aggregate principal amount of Commercial Paper of [petitioner] then outstanding.

With respect to the nature of the obligations of petitioner, the agreement provides:

Obligations of [petitioner] under Section 2 hereof shall remain in full effect during the term of this Agreement and shall not be dependent upon any covenant, performance or other event, other than expressly set forth herein (being the expressed requirements of the existence of a Cash Deficiency and of a demand upon [petitioner] for payment. Except for the right to require the foregoing express requirements to be satisfied, [petitioner] waives any and all other defenses to its obligations under Section 2 herein, including, without limitation, any right of set-off, recoupment, deduction, abatement, suspension, deferment, reduction or other defense or right which [petitioner] may have on account of (a) any claim against [IPFC] or any party to whom any Indebtedness of [IPFC] is owed, whether rising under this Agreement, the Fuel Lease, any other agreement relating to the financing or use of nuclear fuel for the Clinton Plant, or otherwise * * *

As to third parties the agreement provides:

Section 7. *Third Party Beneficiaries.*

The provisions of this Agreement are intended to benefit all holders of Commercial Paper of [IPFC] and any such holder shall be entitled to enforce the provisions of this agreement in its own name.

To satisfy its obligations under the Cash Deficiency Agreement, petitioner obtained a $125,000,000 line of credit from a group of U.S. and foreign banks.

After February 2, 1981, petitioner has been required to make additional payments for nuclear fuel under its contracts with Kerr-McGee, the Department of Energy, and General Electric. In each case, the contractors billed petitioner.[7] Petitioner then invoiced IPFC who sold additional commercial paper and remitted the proceeds to petitioner. As a result of such payments, IPFC's outstanding commercial paper as of the end of 1981 was approximately $57,000,000.

In its 1981 annual report to the ICC, petitioner reported:

> During February, 1981 the Company sold [its] investment of approximately $40 million in nuclear fuel to Illinois Power Fuel Company from which the Company will lease most of [its] nuclear fuel when Clinton Unit 1 becomes operational.

In its 1982 annual report to the FERC, petitioner likewise reported that a $39,810,165 reduction in nuclear fuel materials "represents the Sale to IP Fuel Company." In its 1981 annual report to its shareholders, petitioner reported under the heading "Financings" that "We sold our investment of $39.8 million in Nuclear Fuel in February, 1981 to Illinois Power Fuel Company, an affiliate formed to finance a part of the fuel for Clinton power station Unit 1. We own 50 percent of the fuel company, from which we will lease most of our nuclear fuel." Each of these annual reports also contain the following statement:

> Illinois Power Fuel Company, which is 50 percent owned by the Company, was formed in January, 1981 for the purpose of financing a portion of the nuclear fuel requirements of the Clinton power station. The Company entered into a lease agreement with the Fuel Company under which the Company will lease nuclear fuel. Lease payments, which will be equal to the Fuel Company's cost of fuel as consumed, will begin when the Clinton power station commences pre-commercial operation. The Company is obligated to make subordinated loans to the Fuel Company at any time the obligations of the Fuel Company which are due and payable exceed the funds available to the Fuel Company. The Company's investment of $50,000 is accounted for under the equity method and the lease is accounted for as an operating lease in accordance with an Illinois Commerce Commission order.

In its 1981 income tax return, IPFC indicated:

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[7] Despite the existence of the Bill of Sale, the contracts for nuclear fuel with Kerr-McGee, the Department of Energy, and General Electric were never amended to substitute IPFC for petitioner, and petitioner continued to deal with those contractors as the owner of the fuel.

> In February of 1981, Illinois Power Company (Fed. ID #37-0344645) entered into a sale and leaseback transaction with Illinois Power Fuel Company to effect a financing arrangement for its nuclear fuel being processed for Illinois Power Company's Clinton Plant which is presently under construction.
>
> Under the published guidelines of the Internal Revenue Service in Revenue Ruling 55-540, 1955-2 C.B. 39, Revenue Procedure 75-21, 1975-1 C.B. 715 and other related revenue rulings and procedures, Illinois Power Company continues to be treated as the owner of the Nuclear Fuel after the "sale-lease" transaction because it retains the full incidents and burdens of ownership regardless of the fact that mere legal title is now held by Illinois Power Fuel Company.
>
> Since Illinois Power Company continues to be treated as the owner of the nuclear fuel for tax purposes, the assets involved and related debt are reflected in the tax records of Illinois Power Company along with related items of income and expense.

Respondent determined that as a result of the sale-leaseback transaction, petitioner incurred a $5,604,253 capital gain.[8]

The Lease Charge Deduction

Petitioner could choose to defer payment of any current portion of the lease charges due under the Lease Agreement. Petitioner had elected to defer $6,065,588 in this manner in 1981, but, nevertheless, remained liable for this amount as of December 31, 1981. On its Form 1120 for the calendar year 1981, petitioner claimed an interest expense deduction in the amount of $6,065,528 as a result of its lease payments to IPFC. In his notice of deficiency, respondent disallowed in full this claimed deduction in its entirety.[9]

In its 1980 annual report petitioner announced that it expected to load fuel into the Clinton Power Station in

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[8] The computation is described at note 18 *infra*.

[9] Petitioner conceded that $131,395 of the claimed amount was not deductible for the 1981 calendar year on the ground that such amount was not part of the Monthly Lease Charge required by the Lease Agreement. The remaining $5,934,133 of the claimed deduction is still in dispute, computed as follows:

Interest expense - commercial paper (Morgan Guaranty Trust Co.)	$5,925,495
Amortization - lease finance costs	2,993
organizational expenses	0
Appraisal service - Moody's Investor Service	5,495
Franchise tax	150
Total	5,934,133

January 1983. In its 1982 annual report, petitioner acknowledged that commercial operation of the plant would be delayed past August 1984. At the time of trial, the plant was 97-percent complete.

The Alleged Interest Income

On February 2, 1981, simultaneously with the execution of the Bill of Sale, IPFC's vice president and treasurer, on behalf of IPFC, executed a document entitled "Demand Note Number 1" promising to pay to the order of petitioner $39,810,165.19, plus interest. IPFC made payments on the demand note to petitioner cast in the following form:

Date	*Principal*	*Interest*	*Total*
Mar. 9, 1981	$8,000,000.00	$77,777.78	$8,077,777.78
Mar. 10, 1981	17,000,000.00	170,000.00	17,170,000.00
Mar. 11, 1981	14,810,165.19	152,215.59	14,962,380.78
Total	39,810,165.19	399,993.37	40,210,158.56

For the year ended December 31, 1981, IPFC recorded on its financial records payments of interest to petitioner in the amount of $399,993.37. For that same year, petitioner recorded on its financial records receipt of interest payments from IPFC in the amount of $399,993. This amount was not treated as interest income on petitioner's 1981 tax return, but was treated as such in respondent's notice of deficiency.

OPINION

I. *Preliminary Issues*

Preliminary to our discussion of what we consider to be the primary issues in this case (i.e., whether petitioner's transfer of stock to Millikin University should be disregarded so that IPFC is considered a member of its "affiliated group" for purposes of petitioner's consolidated return, and whether the transfer of nuclear fuel by petitioner which was cast as a sale-leaseback was in reality a financing arrangement for Federal tax purposes), it is important to consider the context in which these questions arise. In the first instance, petitioner is seeking to disavow the form of a transaction structured as a gift, and in the second, petitioner is seeking to disavow the form of a transaction structured as a sale-leaseback. It is significant that in each case, it is the taxpayer and not the Government which seeks to disavow the form of a transaction. As we observed in *Bolger v. Commissioner*, 59 T.C. 760, 767 n. 4 (1973): "the taxpayer may have less freedom than the Commissioner to ignore the transactional form that he has adopted." (Citations omitted.) See also *Bradley v. United States*, 730 F.2d 718, 720 (11th Cir. 1984); *Spector v. Commissioner*, 641 F.2d 376, 381 (5th Cir. 1981), revg. and remanding 71 T.C. 1017 (1979); *Coleman v. Commissioner*, 87 T.C. 178, 201-202 (1986).

Any appeal in the instant case lies to the Court of Appeals for the Seventh Circuit and thus we must look to that court's interpretation of the law in this area. *Golsen v. Commissioner*, 54 T.C. 742, 756-757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971). In this respect, the Seventh Circuit has indicated:

> Resort to substance is not a right reserved for the Commissioner's exclusive benefit, to use or not to use—depending on the amount of the tax to be realized. The taxpayer too has a right to assert the priority of substance—*at least in a case where his tax reporting and actions show an honest and consistent respect for the substance of a transaction.* [*Comdisco, Inc. v. United States*, 756 F.2d 569, 578 (7th Cir. 1985) (emphasis added) (quoting *Weinert's Estate v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961)).]

Here, we are presented with a seemingly disharmonious fact pattern in that, in light of the principles set forth in *Comdisco*, we are convinced that petitioner may attack the form of the sale-leaseback transaction but may not do so with respect to the purported gift. As is more fully discussed below, we reach this seemingly inconsistent result because petitioner's tax reporting and other actions showed an honest and consistent respect for the substance of the nominal "sale-leaseback," but they do not show the same sincerity for the alleged gift.

The Transfer to Millikin University

Petitioner argues that the transfer of 50 percent of IPFC's stock to Millikin University, which was cast in the form of a gift, should be disregarded because beneficial ownership of the stock remained with petitioner as a result of the Stock Restrictions and Stock Transfer Agreement. Hence, argues petitioner, if the gift is disregarded, IPFC becomes a wholly owned subsidiary, and pursuant to sections 1.1502-11 and 1.1502-13, Income Tax Regs., any interest income or gain from the sale-leaseback is not required to be currently reported.

We are of the opinion that in this instance, petitioner may not disavow the form of the gift transaction. The transaction has been consistently characterized by petitioner as a gift. In its petitions to the FERC and ICC for approval of the Nuclear Fuel Agreements, petitioner represented that it would incorporate a subsidiary (i.e., IPFC) and that 50 percent of the subsidiary's stock would be "*donated by the company to a tax exempt organization* or sold to an independent entity." (Emphasis added.) It was with this understanding that the FERC and ICC approved the transaction on December 18, 1980, and December 23, 1980, respectively. On February 2, 1981, petitioner transferred 50 percent of IPFC's stock to Aston & Co., a nominee of Millikin University. For its corporate income tax return for the tax year December 31, 1981, petitioner reported a charitable contribution deduction of $50,000 from the transfer of IPFC stock to Millikin University. It also reported in the Affiliations Schedule attached to the return, that its ownership in IPFC decreased to 50 percent on February 2, 1981, and left blank the space provided for disclosing that equitable ownership of the IPFC stock differed from record ownership of the stock—directly contrary to the position it is now taking. In its 1981 annual report to the FERC, petitioner likewise reported a miscellaneous income tax deduction for the "Donation of IP Fuel Company Stock." Even IPFC, on Schedule H of its 1981 corporate income tax return, reported that it was 50-percent owned by Millikin University.

These facts clearly show that for tax reporting and other purposes, petitioner consistently treated the transfer as a gift. To now allow petitioner to attack the form of a transaction that it structured and respected would run afoul of the principles established in *Comdisco*. It would also create uncertainty in that taxpayers at their whim could choose to respect or not respect transactions depending on which approach would most favor their position at trial. As was stated by this Court in *Groetzinger v. Commissioner*, 87 T.C. 533, 542 (1986):

> In applying the substance-over-form doctrine we are concerned with the intentions *at the time of the agreement* and economic realities *as then perceived by the participants*. [Emphasis added.]

See *Wager v. Commissioner*, 52 T.C. 416, 419 (1969).[10] In the instant case, at the time the stock was transferred by petitioner to Millikin University, the actions of petitioner and IPFC clearly show that they perceived the transfer to be a gift. We are not concerned with petitioner's hindsight perspective of the transaction's potential tax benefits. Accordingly, we conclude that the form of the transfer will not be disregarded and that petitioner may not treat IPFC as a member of its affiliated group for the 1981 tax year.[11]

The Sale-Leaseback Transaction

We are compelled to reach a different result, however, with respect to the sale-leaseback transaction. The transaction was labeled a "sale-leaseback" by petitioner, but it was consistently treated as a financing for tax reporting and other purposes. Although petitioner reported in its annual reports to the ICC, the FERC, and to its shareholders, that it sold approximately $40 million in nuclear fuel to IPFC,[12] each of these reports also contained the following statement:

> Illinois Power Fuel Company, which is 50 percent owned by the Company, was formed in January, 1981 *for the purpose of financing* a portion of the nuclear fuel requirements of the Clinton Power Station. The Company entered into a lease agreement with the Fuel Company, under which the Company will lease nuclear fuel. Lease payments, which

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[10] See also *Emmer v. Commissioner*, T.C. Memo. 1978-102.

[11] This is not to say that the Commissioner is prevented from attacking whatever label the taxpayer attaches to a transaction. See *Gregory v. Helvering*, 293 U.S. 465 (1935). But where the taxpayer has consistently reported a transaction in one manner, then (at least in cases appealable to the Seventh Circuit) he may not be permitted to later claim that the substance of the transaction was something different.

[12] We are mindful that the characterization of a transaction for financial accounting purposes, on the one hand, and tax return purposes on the other, need not necessarily be the same. *Frank Lyon Co. v. United States*, 435 U.S. 561, 597 (1978) (citing *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345, 355 (1971), and *Old Colony R. Co. v. Commissioner*, 284 U.S. 552, 562 (1932)).

> will be equal to the Fuel Company's cost of fuel as consumed, will begin when the Clinton Power Station commences pre-commercial operation. The Company is obligated to make subordinated loans to the Fuel Company at any time the obligations of the Fuel Company which are due and payable exceed the funds available to the Fuel Company. [Emphasis added.]

More importantly, for tax reporting purposes, consistent with its treatment of the arrangement as a financing, petitioner claimed an interest expense deduction of $6,065,528 for the transaction, rather than a gain on the sale of nuclear fuel. Further, the following statement was contained in IPFC's Corporate Income Tax Return (Form 1120) for the 1981 tax year:

> In February of 1981, Illinois Power Company (Fed. ID #37-0344645) entered into a sale and leaseback transaction with Illinois Power Fuel Company to effect a financing arrangement for its nuclear fuel being processed for Illinois Power Company's Clinton Plant which is presently under construction.
>
> Under the published guidelines of the Internal Revenue Service in Revenue Ruling 55-540, 1955-2 C.B. 39, Revenue Procedure 75-21, 1975-1 C.B. 715 and other related revenue rulings and procedures, Illinois Power Company continues to be treated as the owner of the Nuclear Fuel after the "sale-lease" transaction because it retains the full incidents and burdens of ownership regardless of the fact that mere legal title is now held by Illinois Power Fuel Company.
>
> Since Illinois Power Company continues to be treated as the owner of the nuclear fuel for tax purposes, the assets involved and related debt are reflected in the tax records of Illinois Power Company along with related items of income and expense.

The combination of these facts persuades us that petitioner's tax reporting actions have shown an honest and consistent respect for what it considers to be the substance of the Nuclear Fuel Agreements. Its intentions were made clear at the time the agreements were entered into and have continued to be manifested in a similar manner. Thus, under *Comdisco v. United States, supra*, petitioner is not bound to the labels affixed to the transaction, but instead may argue that the economic substance of the arrangement is controlling for Federal tax purposes.[13]

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[13] No evidence has been offered as to the existence of actual or potential "conflicting claims" in this case which was a subject for concern for the Seventh Circuit in *Comdisco*. See *Comdisco v. United States*, 756 F.2d 569, 578 (7th Cir. 1985).

Having decided that petitioner may attempt to disavow the form of the Nuclear Fuel Agreements we must next determine the standard of proof to be applied. Here there is no question that title to the nuclear fuel passed from petitioner to IPFC pursuant to the Bill of Sale.[14] Yet petitioner steadfastly maintains that it, rather than IPFC, was the owner of the nuclear fuel for Federal tax purposes. In such a situation, we have held that because title did vest with someone other than the taxpayer, respondent has made a prima facie case that a sale, rather than a financing, occurred. *Coleman v. Commissioner*, 87 T.C. 178, 204 (1986). As was indicated in *Coleman*, this does not mean that petitioner was not the owner of the nuclear fuel, but that petitioner has the burden of producing, at a minimum, "strong proof"[15] that the other elements of the burdens and benefits of ownership were such that petitioner should be considered the owner of the fuel. 87 T.C. at 204.[16] See *Ullman v. Commissioner*, 264 F.2d 305, 308 (2d Cir. 1959), affg. 29 T.C. 129 (1957); *Schulz v. Commissioner*, 294 F.2d 52, 55 (9th Cir. 1961), affg. 34 T.C. 235 (1960); *Major v. Commissioner*, 76 T.C. 239, 247 (1981); *Lucas v. Commis-*

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[14] As is indicated in our findings, the Bill of Sale provides that petitioner "conveys, transfers, sells, assigns and sets over" the nuclear fuel to IPFC. The Lease Agreement similarly provides that:

"Title to and ownership of the Nuclear Fuel shall at all times remain in Lessor [IPFC] and at no time become vested in Lessee [petitioner] except in accordance with an expressed provision of this Lease. This is a lease only, and shall not give or grant to Lessee any right, title or interest in or to the Nuclear Fuel, or any portion thereof, except the rights of a tenant in accordance with the provisions hereof."

[15] A precise definition of "strong proof" has not been articulated. Suffice it to say that the strong proof standard requires a showing of somewhat more than a preponderance of the evidence and somewhat less than the so-called "Danielson test" under which a party can challenge the form of an agreement "only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), vacating and remanding 44 T.C. 549 (1965), cert. denied 389 U.S. 858 (1967). See *Elrod v. Commissioner*, 87 T.C. 1046 (1986) (strong proof requires "more than a preponderance of the evidence"); *Emmer v. Commissioner*, *supra*; cf. *Schulz v. Commissioner*, 294 F.2d 52, 55 (9th Cir. 1961), affg. 34 T.C. 235 (1960); *Balthrope v. Commissioner*, 356 F.2d 28 (5th Cir. 1966), affg. a Memorandum Opinion of this Court; *Hamlin's Trust v. Commissioner*, 209 F.2d 761 (10th Cir. 1954), affg. 19 T.C. 718 (1953).

The Seventh Circuit, to which an appeal in this case would lie, has apparently indicated its acceptance of the strong proof standard. See *Kreider v. Commissioner*, 762 F.2d 580, 586-587 (7th Cir. 1985), affg. a Memorandum Opinion of this Court.

[16] The Government once again urges us to reject the "strong proof" standard in favor of the stricter standard of *Danielson v. Commissioner*, *supra*. We again refuse to reconsider this matter. See *Lucas v. Commissioner*, 58 T.C. 1022, 1032 n. 1 (1972); *Mittleman v. Commissioner*, 56 T.C. 171, 175 (1971), affd. 464 F.2d 1393 (3d Cir. 1972); *O'Callaghan v. Commissioner*, T.C. Memo. 1984-214.

sioner, 58 T.C. 1022, 1032 (1972).[17] It is these other elements of the benefits and burdens of ownership to which we now turn our attention.

II. *The Sale-Leaseback*

Petitioner argues that it clearly possessed the benefits and burdens of ownership of the nuclear fuel and that the transaction should therefore be viewed as a financing for Federal tax purposes. Respondent takes the position that the substance of the arrangement was a sale-leaseback, and that petitioner must therefore recognize a $5,604,253 capital gain on the sale of the fuel.

A review of the entire record in this case convinces us that petitioner has presented strong proof that it retained the benefits and burdens of ownership of the nuclear fuel, with the result that we will treat the transaction as a financing rather than a sale. In reaching this result, we find the following factors to be particularly persuasive:

(1) *The Terms of Payment*

The payment terms of the transaction reflect a financing rather than a bona fide arm's-length sale. The "purchase price" paid by IPFC for the nuclear fuel, represented the value of the fuel as shown in petitioner's books, or petitioner's total investment in the fuel.[18] No effort was

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[17] It is clear that the "strong proof" rule applies beyond the confines of allocating payments to a covenant not to compete. See *Coleman v. Commissioner*, 87 T.C. 178 (1986) (was transaction a valid sale-leaseback); *Miami Purchasing Service Corp. v. Commissioner*, 76 T.C. 818, 830 (1981) (where did title pass from taxpayer to buyer); *Stephens v. Commissioner*, 60 T.C. 1004 (1973), affd. without opinion 506 F.2d 1400 (6th Cir. 1974) (whether taxpayers were legally obligated to buy stock).

Our suggestion in *Rochester Development Corp. v. Commissioner*, T.C. Memo. 1977-307, that neither the *Danielson* rule nor the "strong proof" rule applied in determining whether a transaction involved a sale or lease was made in the context of a decision which did "not involve an attempt by petitioner to vary the undertakings set forth in the written agreements." See *Coleman v. Commissioner*, *supra* at 202 n. 18.

[18] The Bill of Sale describes the purchase price for the nuclear fuel as follows:

Natural UF6 299,840 kilograms	$28,882,648.83
Prepaid enrichment services to be applied to 157,423 kilogram units of separative work	5,263,199.96
Prepaid enrichment services to be applied to 71,936 kilogram units of separative work	5,664,316.40
Total	39,810,165.19

made by petitioner to sell the fuel at its fair market value and, in fact, as Larry D. Haab, petitioner's senior vice president and chief financial officer, testified at trial,[19] the market value of the fuel may have been actually lower than the book value on the date of the sale.

As is indicated in our findings, petitioner entered contracts with Kerr-McGee Nuclear Corp. for the purchase of raw uranium, with the Department of Energy for uranium enrichment services, and with General Electric Co. for fuel fabrication services. After title to the nuclear fuel had passed to IPFC, payments pursuant to the above contracts were made in the following manner: When a payment became due, petitioner invoiced IPFC who, in turn, sold commercial paper to raise the necessary funds. The cash proceeds from the sale of the commercial paper were then turned over to petitioner, who used the money for the contract payments. By the end of 1981, IPFC had issued approximately $57 million of commercial paper, the proceeds of which were used to finance payments for the nuclear fuel.

The lease payments were structured simply to repay IPFC for the costs incurred by IPFC in financing the payments for the nuclear fuel to the three contractors mentioned above. As is set out in more detail in our findings, under the terms of the Lease Agreement petitioner is required to pay IPFC a sufficient amount to cover: (1) All of IPFC's costs to issue and pay interest on the outstanding commercial paper; (2) any administrative costs incurred by IPFC; and (3) the amounts initially paid by IPFC under the Bill of Sale to acquire the nuclear fuel. The Lease Agreement also provides for a stated return on IPFC's $100,000 equity—the same rate of return permitted by the State of Illinois to petitioner in structuring its utility rates. These payment terms clearly show that the lease was structured to enable petitioner to

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The parties have stipulated that the adjusted basis of the fuel for tax purposes is $34,205,912.99. The difference between $39,810,165.19 and $34,205,912.99 is $5,604,252.10—the amount claimed by respondent to be the capital gain on the transfer of the fuel.

The book value of the fuel is claimed by petitioner to be $39,810,165.19. Although the difference between the book value and the adjusted tax basis for the fuel was not explained at trial, it apparently results from interest expenses and other expenses which were capitalized for regulatory books of account but which were currently expensed for tax purposes.

[19] Throughout trial, we found Mr. Haab's testimony to be forthright, impressive, and entirely believable.

finance its original acquisition costs for the fuel instead of to provide IPFC with a reasonable return for the use of the fuel. In this regard, Mr. Haab testified that petitioner was only concerned with covering IPFC's expenses and having IPFC show a slight profit, but that no consideration was given by petitioner as to the fair rental value of the fuel. Thus, we are convinced that the purchase price and lease payments were structured in the manner of a financing—they reflect the costs of financing the fuel—not an arm's-length bargaining process.

(2) *The Potential for Profit or Loss*

A significant factor to be used in determining ownership of property is the extent to which the taxpayer has potential for profit or loss as a result of holding the property. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 579 (1978); *Sun Oil Co. v. Commissioner*, 562 F.2d 258, 268 (3d Cir. 1977); *Hilton v. Commissioner*, 74 T.C. 305, 350-361 (1980), affd. 671 F.2d 316 (9th Cir. 1982).

In this case, the transaction was structured so that profits and losses resulting from the use of the fuel will inure to petitioner. The nuclear fuel has an estimated useful life of only 3 to 4 years, and as will be shown, the use rights associated with the fuel during this time period remain exclusively with petitioner.

The Bill of Sale provides that, notwithstanding the sale of the nuclear fuel to IPFC, possession of the fuel shall remain with petitioner or a manufacturer. In fact, on the date the Bill of Sale was entered into, IPFC's license permitted it to own the fuel, but it did not permit it to possess the fuel. The Lease Agreement similarly provides that possession of the fuel shall remain with petitioner throughout the term of the lease, which continues through December 31, 2021. The lease further and more importantly provides that petitioner "shall have exclusive possession and use of the Nuclear Fuel." The effect of these lease terms is that petitioner, not IPFC, has the exclusive right to use the fuel throughout its useful life. As petitioner owns the right to use the fuel, profits or losses resulting from the use of the fuel to generate power will inure to petitioner.

IPFC, on the other hand, has a fixed rate of return. The lease payments to IPFC consist of Basic Rent (i.e., the costs of issuing and interest expenses paid on the commercial paper issued by IPFC to finance the acquisition costs of the fuel), Additional Rent (i.e., any administrative or other operating expenses incurred by IPFC), and Burnup Charges (i.e., return of the purchase price originally charged to IPFC for the fuel—to be paid as the Clinton Power Station becomes operational). IPFC was also entitled to the same rate of return on its $100,000 common equity as was used to determine the retail electric rates then in effect for petitioner.[20] Mr. Haab testified that the reasoning behind paying IPFC a return on its equity was merely to enable it to show a nominal profit.

The structuring of the Lease Agreement makes it clear that IPFC had no equity interest in the transaction. The potential profit or risk of loss from using the fuel remained with petitioner.[21] IPFC, with its nominal return, was merely an entity used by petitioner for financing purposes. As was made clear at trial, the reasons behind structuring the transaction in such a manner were threefold: (1) To reduce the overall financing costs of the fuel—this would be achieved as the initial investment in IPFC was nominal ($100,000) and the remaining investment in the fuel (expected to exceed $100 million) could be financed by IPFC at lower rates than would be available to petitioner if it attempted to issue more debt or preferred stock; (2) to enable petitioner to maintain its double A credit ratings on its outstanding debt and preferred stock with the result of leveling its financing costs on these obligations; and (3) to conserve petitioner's bondable additions. The ultimate result of the lower financing costs would be to cause utility rates paid by consumers to be lower than they would otherwise be.

In short, by creating IPFC, petitioner did not create an equity participant with real profit or loss opportunities. It instead simply created a vehicle that could be used by petitioner to achieve lower financing costs.

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[20] At the time of trial the rate being used was 15 percent.

[21] Mr. Haab also testified that the transaction was structured so that IPFC could neither benefit nor suffer from an increase or decrease in the value of the nuclear fuel.

(3) *The Other Benefits and Burdens Retained by Petitioner*

In addition to its right to exclusive use of the fuel, the Lease Agreement bestowed other valuable rights on petitioner. Certain of these bear mentioning. For example, under the terms of the lease, petitioner is designated as the lawful representative of IPFC in all dealings with manufacturers and any regulatory agency having jurisdiction over the ownership or possession of the nuclear fuel. Petitioner is also granted the right to engage in "Fuel Management," which is defined in the lease as "the design of, contracting for, determining the price and terms of acquisition of, management, movement, removal, disengagement, use, storage and other activities in connection with the utilization of the Nuclear Fuel ." In addition, petitioner has the right to move any portion of the fuel to specified locations for storage or servicing. The terms of the lease further provide that to the extent the nuclear fuel is eligible for the job incentive credit, investment tax credit, or service credit, it will be treated as having been acquired by petitioner for that taxable year.

Perhaps petitioner's most significant right is the right to purchase all or any portion of the nuclear fuel from IPFC at any time throughout the term of the lease, regardless of the fair market value of the fuel. To make such a reacquisition, petitioner is merely required to pay IPFC the original amount advanced to it by IPFC plus all of the accrued lease charges.[22]

The Lease Agreement also imposes significant burdens on petitioner. Petitioner is required to pay all taxes and other governmental charges assessed upon IPFC's interest in the nuclear fuel (other than Federal, State, or local income; excess profits; or franchise taxes arising from moneys payable or net income from the Lease Agreement) as well as all of the maintenance and repair expenses necessary to keep the nuclear fuel in good condition.[23] Petitioner is likewise required, at its expense, to procure and maintain all permits and licenses required for ownership or operation of the nuclear fuel.

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[22] More specifically, as is indicated in detail in our findings, petitioner is required to reimburse IPFC the Net Investment Value of the fuel which is essentially the original acquisition cost paid by IPFC as well as any interest and administrative costs owed to IPFC which petitioner was elected to defer. See *supra* note 6.

[23] Under certain limited circumstances, petitioner may request reimbursement of some of these expenses.

Insurance is a major concern of utility companies utilizing nuclear fuel. Here, the Lease Agreement requires petitioner to obtain, without cost to IPFC: (1) Nuclear liability insurance in the maximum amount available from the Nuclear Energy Liability Insurance Association or the Mutual Atomic Energy Liability Underwriters, or both; (2) physical damage insurance for damage arising from nuclear or non-nuclear occurrence in the amount usually maintained by investor-owned utilities operating like properties; and (3) liability insurance in an amount not less than $10 million for non-nuclear liability occurrences with respect to the nuclear fuel. The Lease Agreement also requires petitioner to indemnify IPFC, or any institutional lender that loans money to IPFC, for a wide variety of claims including any injury or death of persons, or physical damage, resulting from any nuclear incident connected with the nuclear fuel.

Nuclear fuel gradually turns into nuclear waste as it is burned in the reactor. Spent fuel must either be reprocessed and separated into recovered forms of radioactive materials, or processed into a form suitable for storage. Under the terms of the lease, petitioner, at its option, must either elect to reprocess the fuel, or elect to purchase the fuel in its spent state. In the event that petitioner elects to purchase the spent fuel, it is still required to pay the net investment value[24] of the fuel to IPFC. As Mr. Haab testified at trial, this payment has no relation to fair market value since, at this stage, the spent fuel actually has a negative value as a result of the significant disposal and storage costs then required to be paid by petitioner.

(4) *The View of the Transaction by Third Parties*

As is indicated in our findings, petitioner, not IFPC, entered into all of the contracts for the acquisition of the nuclear fuel with three contractors: Kerr-McGee Nuclear Corp., the Department of Energy, and General Electric Co. Each of these continued to bill petitioner for the fuel even after title to the fuel was transferred to IPFC. Moreover, when it became necessary to amend the contracts, after title to the fuel had passed, it was petitioner, and not IPFC, who executed the amendments.

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[24] See definition *supra* at note 6.

The moneys used for payments under the above contracts were derived from the issuance of commercial paper by IPFC. The cash proceeds from the sale of the commercial paper were turned over to petitioner, who in turn used the money for the contract payments. Again, petitioner, not IPFC, actually paid the contractors.

It is significant that credit support for the commercial paper was provided by petitioner. The Cash Deficiency Agreement, executed in conjunction with the other Nuclear Fuel Agreements, expressly requires petitioner to maintain unused lines of credit with lending institutions equal to the aggregate principal amount of the outstanding IPFC commercial paper. This condition was in fact complied with by petitioner, in that it obtained a $125 million line of credit from a group of United States and foreign banks. Under the terms of the Cash Deficiency Agreement the line of credit could be utilized by IPFC whenever its aggregate amount of indebtedness then due exceeded its available funds. It is also significant that the Cash Deficiency Agreement contains a section entitled "Third Party Beneficiaries" wherein it is indicated that the provisions of the agreement are intended to benefit all holders of commercial paper of IPFC and that any holder is entitled to enforce the provisions of the agreement in its own name. The Cash Deficiency Agreement additionally required petitioner to waive any defenses it may have to its obligations under the agreement, including any right of setoff, recoupment, suspension, deferment, or other defense petitioner may have as a result of the insolvency of IPFC.

Thus, it is apparent that petitioner retained substantial risks to third parties as to payment of the original acquisition costs of the nuclear fuel, even after petitioner transferred title to the fuel to IPFC.

In conclusion, we note that some of the provisions of the Nuclear Fuel Agreements, when viewed independently, may not brand the transaction as a financing arrangement. On the whole, however, we are convinced that petitioner has presented strong proof that "when the various agreements are probed beneath their labels and are considered in the context of the surrounding facts and circumstances, it strains credulity and offends logic to find that a true sale, to be recognized for tax purposes, had taken place. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1243 (1981). The payments under the Lease Agreement bear marked similarities to debt financing. The rents have no visible connection with the economic value of the property, but instead, reflect interest payments on advances made by IPFC. See *Sun Oil Co. v. Commissioner*, 562 F.2d at 269. As we have discussed, petitioner, as lessee, bore significant burdens, risks, and responsibilities for the nuclear fuel in addition to holding the exclusive-use rights to the fuel during its useful life, and other substantial benefits in connection therewith. These benefits and burdens are strong attributes of ownership—not of a leasehold interest. Finally, the view of the transaction by third parties, as well as petitioner's obligations under the Cash Deficiency Agreement, shows that the incidences of ownership remained with petitioner.

We therefore conclude that the sale-leaseback transaction involved herein was a financing for purposes of the Federal tax laws. Respondent's determination of gain on the "sale" portion of the arrangement will accordingly be disallowed.

III. *Current Deductibility of the Lease Payments*

The third issue for decision is whether petitioner may deduct the liability it accrued for lease charges for its 1981 tax year.

Petitioner argues that as an accrual-basis taxpayer it is entitled to a deduction for the liabilities it accrued for its lease obligations because the obligations satisfy the so-called all-events test. Respondent contends that the deduction is not allowable, arguing that the all-events test has not been met, and alternatively, that the method used by petitioner for accounting for the lease payments does not clearly reflect income as required by section 446(b).[25] We will address these arguments in the order they were raised.

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[25] All statutory references are to the Internal Revenue Code of 1954 as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

The All-Events Test

Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 446(a) provides that taxable income "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Section 446(c)(2) permits a taxpayer to compute taxable income by employment of "an accrual method." An accrual-method taxpayer is entitled to deduct an expense in the year in which it is "incurred," (sec. 162(a)), regardless of when it is actually paid.

The standard for determining when an expense is to be regarded as "incurred" for Federal tax purposes is the "all-events" test prescribed by the Income Tax Regulations. See sec. 1.446-1(c)(1)(ii), Income Tax Regs. (accruals in general); sec. 1.451-1(a), Income Tax Regs. (accrual of income); sec. 1.461-1(a)(2), Income Tax Regs. (accrual of deductions). This test appears to have originated in the Supreme Court's opinion in *United States v. Anderson*, 269 U.S. 422, 441 (1926) ("it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.")

The "all-events" test has two elements, each of which must be satisfied before accrual of an expense is proper. First, all of the events that determine the fact of the liability must have occurred as of the end of the year for which the taxpayer seeks to accrue the liability. Second, the taxpayer must be able to estimate with reasonable accuracy the amount of the expenditure to be made in the subsequent year, as of the end of the year for which the taxpayer seeks to accrue the liability. *United States v. Hughes Properties, Inc.*, 476 U.S. ____ (1986); *Burlington Northern Railroad v. Commissioner*, 82 T.C. 143, 147 (1984); sec. 1.446-1(c)(1)(ii), Income Tax Regs.

(1) *The Fact of the Liability*

Respondent argues that petitioner's liability is contingent, as payments are not required to be made under the terms of the Lease Agreement until the nuclear fuel is loaded into the Clinton Power Station and operations commence. Thus, argues respondent, as of the end of 1981, petitioner had not incurred a deductible liability under the lease, but instead had merely agreed to become liable to make lease payments in the event the nuclear fuel was utilized in the plant. We disagree.

Under the terms of the Lease Agreement, petitioner has an unconditional liability to pay to IPFC the lease obligations that accrue each month. As is explained in more detail in our findings, the lease provides three ways in which lease payments may be made. First, payments may be made each month in the form of Basic Rent.[26] Until the Clinton Power Station commences operations, Basic Rent consists of Monthly Lease Charges, which are essentially all of the financing charges incurred by IPFC in connection with its issued and outstanding commercial paper.

The second method for payment is to pay the Monthly Lease Charges as the plant becomes operational. The terms of the arrangement are such that petitioner (if it chooses) may defer the current payment of the Monthly Lease Charge until such time as burnup of the nuclear fuel commences. Once burnup begins, payments of the Monthly Lease Charge may no longer be deferred. Moreover, as the fuel is consumed, the Monthly Lease Charges which were originally deferred, as well as the current Monthly Lease Charges, are gradually paid off, with the last payment being made when all of the fuel is consumed.

During 1981, in accordance with the second method of payment, petitioner elected to defer any current payment of the Monthly Lease Charges. Hence, as the nuclear fuel is loaded into the Clinton reactor, petitioner will be required to make payments satisfying its accrued liabilities, with all such accrued liabilities being paid by the time the fuel is completely consumed.

The third method of payment under the lease occurs at the time the lease is terminated. The Lease Agreement provides that at that time, petitioner must pay IPFC an amount equal to the Net Investment Value of the fuel. The

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[26] The lease also provides for the payment of Additional Rent from "time to time." However, neither party has argued that any portion of the accrued liability for the lease charge represented Additional Rent.

Net Investment Value of the fuel includes, inter alia, all of the accrued Monthly Lease Charges not yet paid. Thus, petitioner must in any event pay its accrued liabilities no later than the termination of the Lease Agreement on December 31, 2021.[27]

Whether the lease payments are made as Monthly Lease Charges, as the plant becomes operational, or as of the termination of the Lease Agreement, it is clear that in all events, the payments must be made. That petitioner elected to defer payments of the charges until the plant becomes operational is of no significance. The election merely affects the timing and not the certainty of payment of the accrued charge. Even if the plant never becomes operational, the liability is not contingent, as urged by respondent, but it is fixed, and must be paid in any event by the end of the lease. The following words of this Court in *Lukens Steel v. Commissioner*, 52 T.C. 764, 784-785 (1969), affd. 442 F.2d 1131 (3d Cir. [illegible]971), are equally applicable here:

> Accordingly the existence of petitioner's liability and the amount thereof were fixed during the taxable years even though the time of payment was not. * * * In no event could the contingent liability be canceled by petitioner.

Thus, as in *Lukens Steel*, we are convinced that petitioner's liability here was definite during the year in issue even though the exact time of payment was not.

There is some suggestion made by respondent that because of the possibility that the payments may be delayed for 40 years (i.e., until the end of the lease), the liability is so contingent as to render it a nullity. In applying the all-events test in *Reynolds Metals Co. v. Commissioner*, 68 T.C. 943, 960 (1977), we permitted accrual of a liability not paid until 13 years later.[28] In so holding, we indicated:

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[27] Other provisions of the lease provide for payment of this amount if, for any reason, the Lease Agreement terminates before this date.

[28] Courts have generally permitted a deduction under the all-events test even if the liability would not be discharged until the distant future. See, e.g., *United States v. Hughes Properties, Inc.*, 476 U.S. ______ (1986) ("the accrual method itself makes irrelevant the timing factor"); *Lukens Steel Co. v. Commissioner*, 442 F.2d 1131, 1135 (3d Cir. 1971) (uncertainty of the time of payment will not prevent deductibility of any expense that is otherwise deductible under sec. 1.461, Income Tax Regs.); *Denise Coal Co. v. Commissioner*, 271 F.2d 930 (3d Cir. 1959) (payment due 11 years after accrual); *Washington Post Co. v. United States*, 405 F.2d 1279 (Ct. Cl. 1969) (payment could exceed 30 years after accrual); *Jordan v. Commissioner*, 11 T.C. 914, 925 (1948) (proper to accrue interest "even though the course of conduct of the parties indicated that the likelihood of payment of any part of the disallowed portion was extremely

> The crucial point is the legal liability to pay someone at some point in time. We cannot say, if the time period for payment were so stretched as to render the ultimate liability a practical nullity, that our conclusion would remain the same. However the record does not so indicate quite such a stretch-out in the instant case. The amounts in issue for 1962 and 1963 were paid into Trust III by 1975. The payout did not occur "decades hence" and such sums were committed to the trust in the year of accrual. [Citation omitted.]

In the instant case, we need not decide whether a liability paid 40 years after accrual rises to the level of a "practical nullity" because, as of the end of 1981, there was a reasonable expectation[29] that the liability would be paid well before the end of the lease. At the time the Lease Agreement was entered into, petitioner announced in an annual report to its stockholders that the nuclear fuel was expected to be loaded[30] into the Clinton reactor in January 1983. Although there have been some delays, on the date of the trial herein (October 3, 1985), the Clinton Power Station was 97-percent complete, and Mr. Haab testified that the plant would become operational during the early part of 1986. As we have found, the Lease Agreement requires accrued liabilities to be paid as the plant becomes operational. Therefore, in our opinion this is not a situation where the time period for payment is so stretched as to render the liability a practical nullity, rather, under these circumstances there was a reasonable expectation that it would be paid in the very near future.

It is also significant that the Monthly Lease Charge is composed primarily of the interest due on the outstanding IPFC commercial paper. Interest has been defined to include the amount paid for the use of money during the term of a loan.[31] Here, the passage of time during 1981 created the

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doubtful"); *Oxford Inst. v. Commissioner*, 33 B.T.A. 1136 (1936) (payment 10 years after accrual).

For commentary on this subject see Cunningham, "A Theoretical Analysis of the Tax Treatment of Future Costs," 40 Tax. L. Rev. 577, 580 n. 22 (1985); Jensen, "The Deduction of Future Liabilities by Accrual-Basis Taxpayers: Premature Accruals, The All Events Test, and Economic Performance," 37 U. Fla. L. Rev. 443, 469 n. 145 (1985); Aidinoff & Lopata, "Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities To Be Performed in the Future," 33 Tax Law. 789, 801-802 (1980).

[29] See *United Control Corp. v. Commissioner*, 38 T.C. 957, 969-970 (1962).

[30] Generation of electricity begins approximately 6 weeks after the nuclear fuel is loaded into the reactor. The reactor reaches full output about 9 months later.

[31] See *New England Mutual Life Ins. Co. v. Welch*, 153 F.2d 260 (1st Cir. 1946); *Penn Mutual Life Ins. Co. v. Commissioner*, 92 F.2d 962 (3d Cir. 1937); *Pan-American Life Ins. Co.*

interest due under the Monthly Lease Charge. As such, not only did a liability for interest accrue during 1981, but the liability for interest also represents petitioner's *economic cost*[32] for having financed the fuel for that same year.

We are accordingly of the opinion that petitioner adequately established the fact of the liability for the lease payments for the 1981 tax year.

(2) *Reasonable Accuracy*

Respondent argues that the provisions of the lease are "extremely intricate" and that therefore, the actual amounts of petitioner's liability cannot be known with reasonable accuracy.

Although the provisions of the lease are complicated, there is no question that the amount of petitioner's liability for 1981 could be estimated with reasonable accuracy.[33] It is not necessary to set forth here all of the intricacies of the lease terms—they are set out in detail in our findings. For our purposes, we need only show that the lease payment for 1981 was accurately determined.

The 1981 lease payment we are concerned with is termed Basic Rent under the Lease Agreement. Basic Rent is defined in the lease as "the sum of the Monthly Lease Charge, less capitalized Monthly Lease Charges, plus the Burn-up Charge, for the preceding month."

The Monthly Lease Charge consists of three components: First, an interest charge, consisting of all interest expense and amortization of debt discount, whether or not paid, on the outstanding IPFC commercial paper; second, a borrowing charge, consisting of all of the issuing costs incurred by

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v. Commissioner, 111 F.2d 366 (5th Cir. 1940), affd. 311 U.S. 272 (1940); *Fall River Electric Light Co. v. Commissioner*, 23 B.T.A. 168, 171 (1931); *DuPont v. Deputy*, 22 F. Supp. 589 (D. Del. 1938), revd. 103 F.2d 257 (3d Cir. 1939), revd. 308 U.S. 488 (1940).

[32] Although the provisions of the Deficit Reduction Act of 1984 are not applicable here, it is nevertheless noteworthy that in that context the following definition appears: "In the case of interest, economic performance occurs with the passage of time (that is, as the borrower uses, and the lender foregoes use of, the lender's money) rather than as payments are made." Staff of J. Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 265 (J. Comm. Print 1984).

[33] For cases addressing the reasonable accuracy issue, see, e.g., *ESCO Corp. v. United States*, 750 F.2d 1466, 1468-1469 (9th Cir. 1985); *Gillis v. United States*, 402 F.2d 501, 507 (5th Cir. 1968); *Denise Coal Co. v. Commissioner*, 271 F.2d 930, 936-937 (3d Cir. 1959); *Hilinski v. Commissioner*, 237 F.2d 703, 705 (6th Cir. 1956); *Harrold v. Commissioner*, 192 F.2d 1002 (4th Cir. 1951). See also *Ohio River Collieries Co. v. Commissioner*, 77 T.C. 1369 (1981); *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. 497 (1980).

IPFC in connection with issuing the commercial paper; and third, a management charge, consisting of IPFC's projected operating expenses (which is adjusted at the end of the year for the actual operating expenses incurred), and a stated rate of return on IPFC's equity, equal to the amount used to determine the retail electric rates in effect for petitioner in the State of Illinois. From the aggregate of these three amounts is subtracted the amount of IPFC's cash income for the month on the investment of moneys received in connection with transactions contemplated by the lease (other than moneys received pursuant to the management charge). Hence, although the calculations are somewhat complex, *as of the end* of 1981, an *exact amount* could be determined for the combined total of the 12 Monthly Lease Charges for 1981.

The next component of Basic Rent is the adjustment for Capitalized Monthly Lease Charges. This component simply reflects the timing of the payments of Basic Rent rather than the amount owed. For 1981, petitioner elected to defer or "capitalize" all of the current Monthly Lease Charges.

The final component of the equation is the Burnup Charge, which only comes into effect when the Clinton reactor is operational. As the plant did not become operational during 1981, no Burnup Charges were incurred.

In sum, the sole component of Basic Rent which was *incurred* in 1981 was the Monthly Lease Charge. As we have indicated, as of the end of 1981, these charges could not only be determined with reasonable accuracy, but they could also be, and in fact were, determined *exactly*. That petitioner chose to defer these charges does not belie the fact that they were incurred—this only affects the timing of payment, an issue we have fully explored.

Under these circumstances, we therefore conclude that both facets of the all-events test have been met.

Clear Reflection of Income

Respondent contends, citing section 446(b) and *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 410 (5th Cir. 1969), that an allowance of a deduction to petitioner in 1981 for any liability under the Lease Agreement would result in a serious distortion of income.

In the instant matter, respondent did not raise section 446(b) in either the notice of deficiency or pleadings. Nor did petitioner present any evidence on this issue at trial. When faced with similar circumstances in *Seligman v. Commissioner*, 84 T.C. 191, 199 n. 9 (1985), affd. 796 F.2d 116 (5th Cir. 1986), we indicated:

> Sec. 446(b) imposes a burden of proof upon the taxpayer to demonstrate that the Commissioner abused his discretion in changing the taxpayer's accounting method. The burden on petitioner to prove that the Commissioner abused his discretion is heavy. *Resnik v. Commissioner*, 66 T.C. 74, 78 (1976), affd. 555 F.2d 634 (7th Cir. 1977). That burden of proof is heavier than merely proving that the determination of the Commissioner is erroneous. As petitioners were not alerted to respondent's assertion of the sec. 446(b) argument by either the notices of deficiency or pleadings and, therefore, presented no evidence or argument concerning this matter, we will not consider it. *Robertson v. Commissioner*, 55 T.C. 862, 865 (1971); *Philbrick v. Commissioner*, 27 T.C. 346, 353 (1956). [Emphasis added.]

We see no reason to reach a different result here, and accordingly refuse to consider respondent's contention. *Estate of Horvath v. Commissioner*, 59 T.C. 551 (1973); Rule 31(a).

As we have found that the all-events test has been satisfied and that respondent has failed to properly raise his section 446(b) argument, a deduction for the liability incurred in 1981 under the Lease Agreement will be allowed.

IV. *Interest Income*

The final issue for decision is whether petitioner received interest income in connection with the transfer of the nuclear fuel.

On February 2, 1981, simultaneously with the execution of the Bill of Sale, IPFC executed a document entitled "Demand Note Number 1," promising to pay to the order of petitioner $39,810,165.19 (i.e., the "purchase price" for the nuclear fuel), plus "interest." IPFC made payments on the demand note which in form were characterized as follows:

Date	*Principal*	*Interest*	*Total*
Mar. 9, 1981	$8,000,000.00	$77,777.78	$8,077,777.78
Mar. 10, 1981	17,000,000.00	170,000.00	17,170,000.00
Mar. 11, 1981	14,810,165.19	152,215.59	14,962,380.78
Total	39,810,165.19	399,993.37	40,210,158.56

Petitioner contends that during March 1981, IPFC issued commercial paper, in the face amount of $40,850,000, at a discount of $584,217.90, resulting in net proceeds of $40,265,782.10. Petitioner claims that IPFC used $40,210,158.56 of such proceeds to "purchase" the nuclear fuel at the price stated in the sales agreement, $39,801,165.19, plus the "interest" on the demand note ($399,973.37). Thus, argues petitioner, the $399,973.37 is merely part of the total proceeds advanced to petitioner by IPFC, and therefore, should not be treated as interest income. Respondent takes the position that the $399,973.37 was shown as interest income in petitioner's 1981 financial records and should be treated as interest income for Federal tax purposes as well.

We have already held that petitioner retained the benefits and burdens of ownership of the nuclear fuel and that the Nuclear Fuel Agreements, taken together, constituted a financing arrangement. A necessary consequence of this result is a holding that the amount in question ($399,973.37) does not constitute interest but merely represents additional principal loaned to petitioner.

In form, petitioner sold the nuclear fuel on February 2, 1981, for $39,801,165.19, and as this "purchase price" was not paid until March, an additional $399,973.37 cast as "interest" was then added to the "purchase price." In substance, IPFC became obligated to loan petitioner $39,801,165.19 in February 1981, and actually loaned petitioner $40,210,158.56 in March 1981.

This transaction can best be illustrated by the following example. If A agrees to loan $100,000 to B on February 1, but fails to deliver the proceeds until March 1, and as a result of the month delay is required to loan B $110,000, it cannot be said that the additional $10,000 is interest income to B. Interest represents an amount received for the use of money during the term of the loan. [34] In the example, B has not provided A with any funds and therefore cannot be considered to have earned interest. The result of A's failure to provide funds to B is that A foregoes interest income he would have otherwise earned. The $10,000 is simply additional principal that B is later obligated to repay.

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[34] For cases defining "interest," see *supra* note 31.

By replacing A with IPFC, and B with petitioner, in the above example it is clear that the $399,973.37 paid by IPFC to petitioner does not represent interest income to petitioner, but merely represents additional principal.

To reflect the foregoing, as well as concessions, the case will be remanded to the general docket to await disposition of the severed issue.

An appropriate order will be issued.

THEODOROS STAMOS, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 3096-77, 8574-77, 8299-78, 6238-79. Filed December 30, 1986.

Certain language of the stipulation filed herein pertaining to findings of fact set forth in related State court opinions determined to be ambiguous and conditional and therefore such language must be disregarded. Respondent's motion for partial summary judgment based in part on such language is denied. Other issues decided.

Arthur Richenthal, for the petitioner.
George W. Connelly, Jr., for the respondent.

OPINION

SWIFT, *Judge*: This matter is before the Court on petitioner's motion for summary judgment and respondent's motion for partial summary judgment filed pursuant to Rule 121, Tax Court Rules of Practice and Procedure. At issue are excise taxes and additions to tax in excess of $23 million.

The issues in this case arise out of the widely publicized and much litigated Estate of Mark Rothko (hereinafter sometimes referred to as the estate). Our recently filed opinion in *Estate of Reis v. Commissioner*, 87 T.C. 1016 (1986), also involved the Estate of Mark Rothko, excise taxes imposed by respondent on one of the other executors of the Mark Rothko estate, and cross-motions for summary judgment which raised arguments very similar to those raised herein.

Mark Rothko was a well-known American abstract expressionist painter who died in 1970. Petitioner Theodoros Stamos, also an artist, was one of the executors of the estate. Petitioner also served as one of the directors of the Mark Rothko Foundation (the foundation), which was established by Mark Rothko in 1967. In his will, after making certain specific bequests to family members, Mark Rothko bequeathed all of his remaining property to the foundation.

In May of 1970, shortly after Mark Rothko's death, the executors of the estate, including petitioner, entered into contracts on behalf of the estate with the Marlborough Gallery, Inc. (the gallery), under which the paintings of Mark Rothko (which comprised the bulk of the estate's assets) could be sold only by the gallery or its affiliated corporations, offices of which were located throughout the world. The contracts were to last 12 years, and the gallery was to receive a commission of 50 percent of the proceeds from the sale of each painting.

Also in May of 1970, the gallery purchased a painting by petitioner at an auction for $4,000. In January of 1971, petitioner contractually permitted the gallery to serve as the exclusive agent for the sale of his paintings for a 4-year period.

In New York State courts, the surviving members of Mark Rothko's family sued the estate, the executors thereof (including petitioner), and the gallery. The foundation intervened and became a party to the State court proceedings. The litigation, insofar as pertinent to the motions before us, sought to void the 12-year exclusive sales contract between the estate and the gallery, to remove petitioner as an executor of the estate, and to recover monetary damages. Much of the legal relief sought by the surviving family of Mark Rothko was granted by the New York State courts. Petitioner and the other executors of the estate were removed, the contract with the gallery was voided, and monetary damages were awarded to the estate.

The New York litigation did not go unnoticed by the Internal Revenue Service. Respondent's representatives audited the foundation and determined that petitioner was liable for various self-dealing excise taxes under section 4941[1] for the years 1970 through 1976 in the total amount of $19,407,500, and additions to tax under sections 6651(a)(1) and 6684 for the same years in the respective total amounts of $724,375 and $2,957,500.

Petitioner's Motion for Summary Judgment

Petitioner's motion for summary judgment herein is based on three alternative arguments: (1) That section 4941(d)(1)(E) and the related provisions are so vague and imprecise that they are unconstitutional and void; (2) that the assets of the Estate of Mark Rothko were separate and distinct from the assets of the foundation and therefore, that any improper, non-arm's-length conduct that occurred in administering the assets of the estate do not also constitute self-dealing in the use of the assets of the foundation; and (3) that whatever misuse of the assets of the foundation may have occurred, under the undisputed facts of this case, such misuse did not constitute self-dealing by petitioner because the assets of the foundation were not used for the benefit of or transferred to petitioner. Each of these arguments was addressed in *Estate of Reis v. Commissioner, supra*, and either was resolved against Reis' estate in favor of respondent or was considered not ripe for disposition by way of summary judgment. Our resolution of these issues in *Estate of Reis* controls our resolution of these issues herein. We therefore deny petitioner's motion for summary judgment.

Respondent's Motion for Partial Summary Judgment

Respondent's motion for partial summary judgment is based on his contention that there is no factual dispute herein and that respondent is entitled to summary judgment on the issue of whether petitioner Theodoros Stamos committed "acts of self-dealing" under section 4941. Respondent argues that the acts of self-dealing are established by: (1) Certain findings made by the New York State courts in the litigation concerning the Estate of Mark Rothko; (2)

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[1] All section references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

stipulated facts herein concerning the purchase by the gallery of one of petitioner's paintings; and (3) stipulated facts herein concerning the agency relationship between the gallery and petitioner for the sale of petitioner's paintings.

Findings of New York State Courts

With regard to the opinions of the New York State courts (citations to which are found in our opinion in *Estate of Reis v. Commissioner, supra*), respondent argues that under the principle of judicial notice set forth in rule 201 of the Federal Rules of Evidence, we are entitled to find as facts herein the findings of fact reflected in the opinions of the New York State courts in the litigation concerning the Estate of Mark Rothko. We concluded in *Estate of Reis*, that a proper application of judicial notice will not allow us herein to make findings of fact in this Court based on findings of fact made in the referenced New York litigation, and our decision in *Estate of Reis* is controlling herein on that argument.

Also with respect to the opinions of the New York State courts in the litigation concerning the Estate of Mark Rothko and independently of the principle of judicial notice, respondent argues that the findings of fact of the New York State courts have been stipulated to as facts herein. Respondent's argument is based on the language of paragraph 8 of the stipulation of facts filed in this case. After setting forth the citations to the various New York State court opinions, paragraph 8 of the stipulation reads as follows:

> To the extent the parties consider the circumstances, findings or holdings of those proceedings relevant to the issues in these cases, they have made them a part of the Stipulation.

Generally, a stipulation of fact is controlling on the parties, and the Court is bound to enforce it. Rule 91, Tax Court Rules of Practice and Procedure. Rule 91 provides in part as follows:

> (e) Binding Effect: A stipulation shall be treated, to the extent of its terms, as a conclusive admission by the parties to the stipulation, unless otherwise permitted by the Court or agreed upon by those parties. The Court will not permit a party to a stipulation to qualify, change, or

> contradict a stipulation in whole or in part, except that it may do so where justice requires. * * *

Stipulations that specific evidence will not be introduced into evidence are valid. *Blum v. Morgan Guaranty & Trust Co. of New York*, 709 F.2d 1463, 1465 (11th Cir. 1983); *United States v. Cale*, 508 F. Supp. 1038, 1043-1044 (S.D. N.Y. 1981). Stipulations on legal issues such as the admissibility of evidence, however, are uniquely within the province of the Court to determine and are not binding on the Court. *United States v. Dyer*, 752 F.2d 591, 595 (11th Cir. 1985); *Fisher v. First Stamford Bank & Trust Co.*, 751 F.2d 519, 523 (2d Cir. 1984); *Noel Shows, Inc. v. United States*, 721 F.2d 327, 330 (11th Cir. 1983); *King v. United States*, 641 F.2d 253, 258 (5th Cir. 1981); *United States v. Waterman S.S. Corp.*, 397 F.2d 577, 579 (5th Cir. 1968); *Drasner v. Thomson McKinnon Securities, Inc.*, 433 F. Supp. 485, 490 (S.D. N.Y. 1977).

Stipulations, like contracts, bind parties only to the terms actually agreed upon. *United States v. McKinney*, 758 F.2d 1036, 1047 (5th Cir. 1985); *Rice v. Glad Hands, Inc.*, 750 F.2d 434, 438 (5th Cir. 1985). The interpretation of a stipulation primarily is determined by ascertaining the intent of the parties, and such intent is a question of fact. *WO Co. v. Benjamin Franklin Corp.*, 562 F.2d 1339, 1344 (1st Cir. 1977); *Stella v. DePaul Community Health Center*, 487 F. Supp. 1017, 1020 (E.D. Mo. 1980), affd. 642 F.2d 258 (8th Cir. 1981).

The language of a stipulation is to be construed pursuant to rules applicable to the construction of contracts. *In re Neuman*, 55 Bankr. 702, 705 (S.D. N.Y. 1985); *In re Bolton Hall Nursing Home*, 31 Bankr. 765, 769 (Bankr. D. Mass. 1980); *Nishman v. DeMarco*, 76 App. Div. 2d 360, 430 N.Y.S.2d 339, 344 (1980). Where language in a stipulation is so ambiguous that the intent of the parties cannot be discerned, the language in question will be disregarded, and the Court will not construe a stipulation to exist where the parties have not clearly set forth the substance of what they have agreed to. Cf. *National Audubon Society, Inc. v. Watt*, 678 F.2d 299, 306-307 (D.C. Cir. 1982); *New Educational Development Systems, Inc. v. Boitano*, 573 F. Supp.

594, 596-597 (N.D. Cal. 1983); *Mann v. Fender*, 587 S.W.2d 188, 202 (Tex. Civ. App. 1979).

We reiterate and emphasize what previously has been said concerning the stipulation process—

> Economy of the time of both litigants and courts is greatly favored, and no more useful device is found than the stipulation which agrees to the existence of material and relevant facts concerning which there is no dispute, thus avoiding time-consuming and unnecessary presentation of proof. * * * The stipulation is to be encouraged as an efficient means of presenting evidence * * * [*Insurance Co. of No. Amer. v. Northwestern Nat. Ins. Co.*, 494 F.2d 1192, 1196 (6th Cir. 1974).]

Applying the above principles to respondent's argument, it can only be concluded that the language in question from the stipulation filed herein is so ambiguous and indefinite that it does not constitute a stipulation at all. Perhaps it represents an agreement between the parties to attempt to agree later, but certainly it cannot fairly be read to constitute a present agreement that the findings of the New York State courts are to be regarded as stipulated facts in this case.

The major problem with respondent's argument pertaining to the above language of the stipulation centers on the following phrase from paragraph 8 of the stipulation: "To the extent the parties consider the circumstances, findings, or holdings * * * relevant." We simply do not know the answer to the question implicitly raised by that language—namely, to *what* extent did or do the parties consider the circumstances, findings, or holdings of the New York State court opinions relevant to these proceedings. Based on the conditional language of the stipulation, the parties themselves must yet agree on that point before the remaining language of that sentence of paragraph 8 of the stipulation becomes operative.

If the parties had left the question of relevancy to the Court (as is normally done) and merely stipulated to the findings of the New York State courts without any further conditions, we would consider those findings to have been fully stipulated herein. We would determine the relevancy of those findings and make our findings accordingly.[2] Our best reading of the stipulation, however, suggests that the parties conditioned their stipulation or agreement on this point upon a further stipulation as to the relevancy of the findings of the New York State courts. Because no such further stipulation occurred, the language in question is meaningless, and the Court must disregard it.

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[2] Where parties to a Federal court proceeding stipulate that findings of a State court will be part of the record in the Federal court proceeding, such findings of the State court may serve

In light of the ambiguous and conditional nature of the language of paragraph 8 of the stipulation, we find that the parties herein have not stipulated that the findings of fact contained in the New York State court opinions concerning the Estate of Mark Rothko are facts upon which we may base our findings in this proceeding.

Purchase of Petitioner's Painting and Agency Contract with the Marlborough Gallery

Respondent also moves for partial summary judgment on the grounds that, as a matter of law, the purchase by the gallery of a painting by petitioner and the presence of the exclusive agency contract petitioner entered into with the gallery constitute acts of self-dealing. Respondent has not referred us to any particular provision of section 4941(d)(1) that would support such a holding,[3] and we have not identified one. The provisions of section 4941(d)(1)(A) through (E) pertain to transactions between a disqualified

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as the basis for the Federal court's decision. *Hagan v. California*, 265 F. Supp. 174, 175 (C.D. Cal. 1967).

[3] Sec. 4941(d)(1) provides as follows:

SEC. 4941(d). SELF-DEALING.—

(l) IN GENERAL.—For purposes of this section, the term "self-dealing" means any direct or indirect—

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

(F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946(c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.

person and a private foundation, and the provisions of section 4941(d)(1)(F) pertain to transactions between a private foundation and a Government official. The sale by petitioner of one of his paintings to the gallery, and the agency contract between petitioner and the gallery, do not appear to be the types of transactions described in section 4941(d)(1).

For the reasons stated above, petitioner's motion for summary judgment and respondent's motion for partial summary judgment will be denied.

Appropriate orders will be issued.

ALBERT F. AND IDA E. WEDVIK, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 21304-84. Filed December 30, 1986.

Petitioners claimed charitable contribution deductions for payments made to various Universal Life Churches and to a fund established and maintained by the Universal Life Church, Inc., of Modesto, California. However, all such payments were repaid to petitioners or to their own Universal Life Church. *Held*, petitioners are not entitled to a charitable contribution deduction because no actual contributions were made. Sec. 170(a), I.R.C. 1954; *Davis v. Commissioner*, 81 T.C. 806 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985); *Glynn v. Commissioner*, 76 T.C. 116, 121-122 (1981), affd. without published opinion 676 F.2d 682 1st Cir. 1982); *Sims v. Commissioner*, 72 T.C. 996, 1008-1009 (1979). *Held, further*, petitioners are liable for additions to tax for fraud. Sec. 6653(b), I.R.C. 1954.

Peter R. Stromer, for the petitioners.
Hugh M. Spall, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioners' Federal income tax and additions to tax as follows:

Taxable year	*Deficiency*	*Additions to tax* Sec. 6653(b)(1)[1]	Sec. 6653(b)(2)
1980	$5,479	$2,739.50	0
1981	6,691	3,345.50	0
1982	6,796	3,398.00	50% interest due on $6,796

n his answer respondent alleged, as an alternative to the mposition of the additions to tax for fraud, that petitioners re liable for additions to tax under section 6653(a) and for lamages under section 6673.

The issues presented are: (1) Whether petitioners are ntitled to deduct alleged charitable contributions made to everal chartered congregations of the Universal Life hurch, Inc., and to a fund maintained by the Universal ife Church, Inc.; (2) whether petitioners are liable for dditions to tax under section 6653(b); and (3) if we find hat imposing the additions to tax under section 6653(b) is nappropriate, whether petitioners are liable for additions to ax under section 6653(a) and damages under section 6673.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of acts and the attached exhibits are incorporated by this eference.

Albert F. and Ida E. Wedvik (petitioners) resided in Vashington State during the taxable years in issue and at he time they filed their petition in this case. Petitioners iled joint Federal income tax returns for the taxable years 980, 1981, and 1982.

Sometime prior to 1980 petitioners applied for and eceived Universal Life Church (ULC) charter number 32731 rom the Universal Life Church, Inc., of Modesto, California ULC, INC.). On December 24, 1979, petitioners opened a hecking account with Seattle First National Bank in the ame of Universal Life Church, Inc., charter number 32731, vith a deposit of $11,743.59. Petitioners and Aileen Wedvik, whose relationship to petitioners is not known, were the sole signatories of this account. Throughout the taxable years in issue, checks were drawn on this account to pay petitioners' personal expenses including mortgage payments on their home, utilities, magazine subscriptions, the cost of travel to Mexico, and payments made for the "Health and Welfare" of petitioners. Petitioners also maintained a personal checking account at Seattle First National Bank.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect uring the taxable years in issue, and all Rule references are to the Tax Court Rules of ractice and Procedure.

During the taxable year 1980, the following friends or acquaintances of petitioners held church charters from ULC, INC.:

	Charter No.	*Name of spouse*
Julius Mink	30674	Virginia
Edward Mink	34208	Sunshine
Terence Chapin	22994	Lynn
Dorothy Brooks	39029	Ronald

During the taxable year 1980, petitioners drew checks on their personal account payable to their church and to various other ULC churches as follows:

Charter No.	*Charter holder*	*Total value of checks*
30674	Julius Mink	$10,260
22994	Terence Chapin	1,350
34208	Edward Mink	2,835
Unidentified charters		860

During the taxable year 1981, petitioners also drew checks on their personal account payable to the ULC churches controlled by Edward Mink, Julius Mink, and Terence Chapin totaling $650, $1,000, and $400, respectively.

Although these payments were ostensibly made as charitable contributions to the respective ULC churches, a close examination of the bank records reveals that almost every, if not every, dollar paid to these other ULC churches was repaid to petitioners by way of direct or indirect payments from the other ULC charter holders to petitioners' church. In their simplest form, the repayments of alleged charitable contributions made by petitioners are illustrated by the transactions that occurred on June 14, 1980. On that date, petitioners purportedly donated $260 to Universal Life Church charter number 22994 by check drawn on their personal bank account. Universal Life Church charter number 22994 was issued to Terence Chapin. Lynn Chapin, wife of Terence Chapin, then signed a receipt indicating the $260 donation by petitioners. Contemporaneously, the Chapins drew a check in the amount of $260 from their personal bank account payable to Universal Life Church charter number 32731, which was controlled by petitioners.

Petitioners also engaged in many more complicated check swaps with ULC charter holders. The transactions that occurred in July 1980 are illustrative of the machinations in which petitioners engaged. On July 14, 1980, Julius Mink wrote a check payable to petitioners' ULC church in the amount of $825. On the same day, Edward Mink wrote a check payable to petitioners' ULC church in the amount of $375. With checks dated July 15, 1980, petitioners made payments of $825 and $375 to the ULC churches controlled by Edward Mink and Julius Mink, respectively. Receipts for these payments were issued to petitioners. As a result of these transactions, petitioners drew checks on their personal bank account in the total amount of $1,200, and deposits totaling $1,200 were made in their church bank account. Although it appears that the ULC church controlled by Edward Mink received $450 more than he paid out of his personal account, and Julius Mink $450 less, an inspection of the bank records of Julius Mink's ULC church reveals that, 3 days prior to the above check swaps, Edward Mink paid $450 to Julius Mink's ULC church. The following chart summarizes the above transaction with credits indicating payments from the individuals' personal accounts and debits indicating donations to their respective ULC churches:

Date	*Petitioners*	*Julius Mink*	*Edward Mink*
7/11/80		$450	($450)
7/14/80	$825	(825)	
7/14/80	375		(375)
7/15/80	(825)		825
7/15/80	(375)	375	
	0	0	0

In early 1981, petitioners ceased exchanging checks with other ULC charter holders and began making regular payments to the Universal Life Church Receipts and Disbursements Trust Fund, a fund established and maintained by personnel connected with ULC, INC. Beginning May 11, 1981, and continuing throughout the taxable years 1981 an 1982, petitioners regularly drew checks on their persona account payable to cash almost always in the amount o $1,000. Donation receipts were then issued and stampe with the signature of Keith L'Hommedieu, an individua associated with ULC, INC., in the amount of $1,000. At th same time a check or checks were drawn on a checking account maintained in the name of Universal Life Church Receipts and Disbursements Trust Fund at the East Santa Cruz branch of Bank of America and made payable t petitioners, their ULC church, or both. These checks, which were also stamped with the signature of Keith L'Hommedieu, invariably totaled an amount just less than $1,000. If more than one check was written to petitioners or their ULC church on the receipts and disbursements trust fund account, such checks would be in sequential order and were written in odd dollar amounts.

The transactions occurring in early June 1981, provide an excellent example of this check swap. On June 1, 1981, petitioners drew a check on their personal checking account to cash in the amount of $1,000. A receipt dated June 3, 1981, and stamped with the signature of Keith L'Hommedieu was issued to petitioners to acknowledge an alleged charitable contribution of $1,000. Simultaneously, three checks, numbers 1857, 1858, and 1859, were drawn on the receipts and disbursements trust fund account and stamped with the signature of Keith L'Hommedieu. Check numbers 1857 and 1858, in the respective amounts of $109.77 and $258.13, were made payable to Albert Wedvik. Check number 1859 in the amount of $628.35 was made payable to Universal Life Church with a memo notation to "32731," petitioners' ULC charter number. This transaction may be summarized as follows:

Date	*Check drawn on petitioners' personal account to cash*	*ULC receipt amount*	*Checks drawn on receipts and disbursements trust fund account payable to*	
			Petitioners	*ULC 2731*
6/1/81	$1,000			
6/3/81		$1,000		
6/4/81			$258.13	
			109.77	$628.35
			$996.25	

The following table lists the dates and the amounts of the ULC receipts stamped with the signature of Keith L'Hommedieu, along with the amounts of checks drawn on petitioners' personal checking account payable to cash, and the amounts of checks drawn on the receipts and disbursements trust fund account made payable to petitioners, their church, or both:

ULC receipts		*Checks drawn on petitioners' account*	*Checks drawn on receipts and disbursements trust fund account payable to:*		
Date	*Amount*	*Amount*	Petitioners	*Church*	*Total*
1981					
May 14	$1,000	$1,000	...	$976.58	$976.58
May 21	1,000	1,000	...	998.75	998.75
June 3	1,000	1,000	[1]$367.90(2)	628.35	996.25
Sept. 3	1,000	1,000	213.00	784.50	997.50
Sept. 14	1,000	1,000	769.68(2)	226.57	996.25
Sept. 25	1,000	1,000	464.80(2)	531.45	996.25
Oct. 6	1,000	...	478.87(2)	507.13	986.00
Oct. 16	1,000	1,000	355.15(2)	641.10	996.25
Oct. 30	1,000	...	...	998.75	998.75
Nov. 13	1,000	1,000	357.77(2)	638.48	996.25
Nov. 20	1,000	...	...	998.75	998.75
Dec. 4	1,000	...	588.17(2)	408.08	996.25
Dec. 11	1,000	1,000	57.60	939.90	997.50
Dec. 18	1,000	1,000	...	998.75	998.75
Dec. 29	1,000	700	...	998.75	998.75
Dec. 30	1,000	...	...	998.75	998.75
1982					
Feb. 16	1,000	1,000	541.94(2)	...	541.94
Feb. 25	1,000	1,000	530.54(2)	...	530.54
Mar. 16	1,000	1,000	627.46(2)	...	627.46
Apr. 12	1,000	1,000	214.58	...	214.58
May 3	1,000	1,000	622.88	...	622.88
May 21	1,000	...	552.74(2)	443.51	996.25
June 9	1,000	...	431.17(2)	565.08	996.25
June 22	1,000	...	...	998.75	998.75
July 9	1,000	1,000	733.45(2)	262.80	996.25
July 30	1,000	1,000	289.11	708.39	997.50
Aug. 11	1,000	...	296.61(2)	697.39	994.00
Sept. 30	1,000	1,000	973.82(2)	20.18	994.00
Oct. 18	1,000	...	983.61	12.39	996.00
Oct. 27	1,000	1,000	...	...	...
Nov. 1	1,000	...	839.80(2)	154.20	994.00
Nov. 19	1,000	1,000	207.38(2)	786.62	994.00
Dec. 6	1,000	750	885.65(2)	108.35	994.00
Dec. 16	1,000	600	125.52(2)	868.48	994.00
Dec. 29	1,000	...	...	...	...
Dec. 31	1,000	...	...	...	...

[1] The numbers enclosed in parentheses indicate the number of checks, if more than one, the amounts of which were summed to arrive at the figure given in the table.

On March 24, 1980, petitioner Albert F. Wedvik con pleted a Form W-4, Employees' Withholding Allowanc Certificate, upon which he claimed nine withholding exem tions.

On their joint Federal income tax returns, petitioner claimed charitable deductions for contributions to the Un versal Life Church in the amounts of $17,455, $18,090, an $19,010 for the taxable years 1980, 1981, and 198 respectively. In his statutory notice of deficiency mailed o April 4, 1984, the Commissioner disallowed the deduction claimed for contributions to churches controlled by petitio ers, other individuals, and to the fund established an administered by persons associated with ULC, INC. Th notice of deficiency did not disallow contributions claime by petitioners for the taxable years in issue in the amount of $40, $110, and $150.

During the audit of petitioners' Federal income ta returns commenced in 1983, the revenue agent assigned t the audit issued a written request that petitioners produc documentation substantiating the claimed charitable contri butions including receipts and canceled checks. Petitioner supplied only receipts signed by those individuals wh controlled ULC churches with which petitioners had ex changed checks as well as those stamped with the signatur of Keith L'Hommedieu. Petitioners did not produce an copies of canceled checks.

Subsequently, the revenue agent issued an administrativ summons to Seattle First National Bank requiring th production of all bank records for the years 1980 throug 1982 relating to all accounts in the name of or under th signatory control of petitioners. On November 10, 1983 petitioners filed a petition to quash this summons in U.S District Court for the Western District of Washington. Th petition was denied by the District Court and the summoned records were produced.

OPINION

In this case, petitioners present more tiresome claims to deductions for alleged contributions to the Universal Life Church. Like the many preceding cases, petitioners' claims do not even pass the smell test. However, this case is made more malodorous because of the taint of fraud occasioned by petitioners' various check-swapping schemes.

Petitioners claim that they are entitled to deduct the payments made to various churches chartered by ULC, INC., including their own, and to a fund established and maintained by personnel associated with ULC, INC. Deductions for charitable contributions are authorized by section 170, provided the contributions are made to or for the use of (l) a corporation, trust, or community chest, fund, or foundation, (2) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, and (3) no part of the net earning thereof inures to the benefit of any private shareholder or individual. Sec. 170(c)(2). Section 170 also provides that a deduction is allowable only for charitable contributions where the payment thereof is made within the taxable year. Sec. 170(a). To show that payment of the claimed contribution was made during the taxable year, the taxpayer must show that he departed with dominion and control over the alleged gift. Davis v. Commissioner, 81 T.C. 806, 817 (1983), affd. without published opinion 767 F.2d 931 (9th Cir. 1985); Glynn v. Commissioner, 76 T.C. 116, 121-122 (1981), affd. without published opinion 676 F.2d 682 (lst Cir. 1982).[2] Furthermore, no deduction will be allowed where the taxpayer expects some economic benefit in return for the alleged gift. *Sims v. Commissioner*, 72 T.C. 996, 1008-1009 (1979); *Rusoff v. Commissioner*, 65 T.C. 459, 469 (1975), affd. without published opinion 556 F.2d 559 (2d Cir. 1977); *DeJong v. Commissioner*, 36 T.C. 896, 899 (1961), affd. 309 F.2d 373 (9th Cir. 1962). The burden of proving entitlement to a charitable deduction is on petitioners. *Deputy v. duPont*, 308 U.S. 488 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); Rule 142(a).

Based upon our review of the record, we conclude that petitioners have fallen woefully short of satisfying their burden of proof. Petitioners systematically met with indivi uals who controlled churches chartered by ULC, INC., ar exchanged checks purporting to be contributions to eac respective church. Petitioners drew checks on their person checking account payable to the ULC churches controlled b Julius Mink, Edward Mink, Terence Chapin, and Doroth Brooks. At the same time, the alleged contributions we repaid to petitioners by payments to their ULC church b Julius Mink, Edward Mink, Terence Chapin, and Doroth Brooks. Sometimes the repayment was direct; at oth times, the repayment was effected by multiple check swap which served to disguise the repayment.

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[2] See *Odd v. Commissioner*, T.C. Memo. 1984-180.

Beginning in 1981, petitioners began making payments t the Universal Life Church Receipts and Disbursement Trust Fund, a fund established and maintained by personn associated with ULC, INC. Petitioners received receipt indicating that they had made a charitable contribution t the Universal Life Church. Simultaneously, a check o checks were drawn on the receipts and disbursements trus fund bank account made payable to petitioners, their UL church, or both. These repayments invariably totale slightly less than the payments made by petitioners. Fo example, on or about June 1, 1981, petitioners drew a chec on their personal account payable to cash in the amount o $1,000. Petitioners then likely mailed the $1,000 in cash o a money order to Keith L'Hommedieu of ULC, INC., wh then issued a receipt in the amount of $1,000 dated June 3 1981. In addition, L'Hommedieu issued three checks on th receipts and disbursements trust fund bank account payabl to petitioners and their ULC church in amounts totaling $996.25.

Petitioners did not offer any plausible explanation for the repayments of their alleged charitable contributions. In his testimony, petitioner Albert Wedvik simply stated that he did not know that petitioners' contributions to the various other ULC churches and to the receipts and disbursements trust fund would be repaid.[3] We find his testimony to be completely incredible. The long-standing pattern of repayment compels the conclusion that petitioners simply had to have agreed with the other ULC charter holders and Keith L'Hommedieu, in advance, that all contributions would be repaid.

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[3] Petitioner Ida E. Wedvik did not testify and the parties stipulated that her testimony would be the same as her husband in all essential particulars.

We give little weight to the fact that a few of the check swaps with other ULC charter holders appear not to have been complete wash transactions. We quite readily attribute small differences occasionally appearing in the amounts of the checks given and received (e.g., $25) to the exchange of cash between the parties.

We also acknowledge that, on occasion, petitioners' bank records do not reflect that any check was drawn on their personal account, or that a check in an amount less than $1,000 was written, prior to the issuance of a receipt and checks by the receipts and disbursements trust fund. However, petitioners readily could have made these payments with cash from other sources. Cash transactions could not, of course, be easily traced through petitioners' bank records. Similarly, in early 1982, repayments from the receipts and disbursements trust fund appear to be far less than the typical amount. Again additional repayments could have been made in cash by L'Hommedieu to bring the total to approximately $1,000.

We point out that frequently the difference between the $1,000 alleged contributions made by petitioners and the repayments are only small amounts, which look suspiciously like service charges for each check written by L'Hommedieu. For example, in the transactions of early June 1981, petitioners received repayments in three separate checks totaling $996.25. The shortfall of $3.75 apparently represents a service charge of $1.25 per check. A review of the chart reproduced earlier suggests that this service charge was increased to $2 per check in August 1982.

Because we find that petitioners did not relinquish dominion and control over their alleged charitable contributions (*Davis v. Commissioner, supra*, *Glynn v. Commissioner, supra*), and that petitioners expected and received a substantial quid pro quo for the alleged contributions (*Sims v. Commissioner, supra*), we conclude that they did not make any contributions. As a result, we need not consider whether the payments were made to charitable organizations under section 170(c)(2) except to the extent petitioner made payments directly to their ULC church.

Petitioners have not demonstrated that their church wa a corporation, trust, or community chest, fund, or foundation. Sec. 170(c)(2)(A). Likewise, petitioners have not demonstrated that their church was organized for an exempt purpose. Sec. 170(c)(2)(B). Petitioners did not introduce any evidence, such as articles of incorporation, trust documents, or other legal governance documents, that would indicate that the purposes of the church were limited to exclusively exempt purposes. Lastly, petitioners have not demonstrated that the net income of their church did not inure to the benefit of themselves or any other private individual. Sec. 170(c)(2)(C). In fact, we find that there was substantial personal inurement inasmuch as checks were drawn on the church account to pay petitioners' monthly mortgage payments as well as the costs of utilities, magazine subscriptions, a trip to Mexico, and payments for the "Health and Welfare" of petitioners. In sum, the payments made by petitioners to their church are not deductible charitable contributions for the same reasons given in the many Universal Life Church cases that have preceded this one.[4]

We must now decide whether petitioners are liable for additions to tax for fraud under section 6653(b). Under section 6653(b), respondent has the burden of proving by clear and convincing evidence that at least part of an underpayment of tax for the taxable years in issue was due to petitioners' fraud with intent to evade tax. Sec. 7454(a); Rule 142(b); *Doncaster v. Commissioner*, 77 T.C. 334 (1981); *Marcus v. Commissioner*, 70 T.C. 562 (1978), affd. without published opinion 621 F.2d 439 (5th Cir. 1980). This burden is met if it is shown that the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes, and that there is an underpayment of tax. *Stoltzfus v. United States*, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); *Rowlee v. Commissioner*, 80 T.C. 1111, 1123 (1983). Fraud will never be presumed. *Beaver v. Commissioner*, 55 T.C. 85, 92 (1970). However, because direct proof of an intent to defraud is seldom possible, respondent may show fraud by circumstantial evidence. *Stephenson v. Commissioner*, 79 T.C. 995, 1005-1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984). The existence of fraud is a question of fact to be resolved upon consideration of the entire record. *Rowlee v. Commissioner, supra* at 1123. Upon consideration of the entire record, we conclude that respondent has sustained his burden of proof by clear and convincing evidence for each of the taxable years in issue.

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[4] No good purpose would be served by listing the multitude of cases wherein this Court has rejected claimed deductions for contributions to churches chartered by the Universal Life Church. However, the following is a partial listing of the numerous ULC cases:

Bell v. Commissioner, 85 T.C. 436 (1985); *Roben v. Commissioner*, T.C. Memo. 1986-48; *Grew v. Commissioner*, T.C. Memo. 1986-47; *Van Cleve v. Commissioner*, T.C. Memo. 1985-546; *Botwinick v. Commissioner*, T.C. Memo. 1985-501; *Kalgaard v. Commissioner*, T.C. Memo. 1984-283, affd. 764 F.2d 1322 (9th Cir. 1985). See also *Rager v. Commissioner*, 775 F.2d 1081 (9th Cir. 1985), affg. an unpublished order of this Court; *Larsen v. Commissioner*, 765 F.2d 939 (9th Cir. 1985), affg. an order of dismissal of this Court (sanctions imposed for frivolous appeal).

During the taxable years in issue, petitioners made payments to various ULC chartered churches and to a fund established and maintained by personnel connected with ULC, INC. Petitioners reported these payments on their Federal income tax returns as deductible charitable contributions. However, the record reveals that these payments were made with the understanding that they would be immediately repaid to petitioners either directly or through their ULC chartered church. Despite their protestations that they did not know that the payments would be returned, we believe petitioners knew they were not making contributions of any sort. The check swapping scheme, employed with varying degrees of complexity, is compelling circumstantial evidence that petitioners knew they were not entitled to charitable contribution deductions. The plan to exchange funds with other ULC churches and with the receipts and disbursements trust fund could only have been implemented in an attempt to mislead the IRS to believe that legitimate contributions were made. Because both petitioners participated in these schemes, we uphold the determination of the Commissioner with respect to fraud as to both. Cf. *Fowler v. Commissioner*, T.C. Memo. 1984-311.

Although we find that the elaborate check-swapping schemes employed by petitioners provide sufficient evidence to carry respondent's burden of proof, there are other indicia of fraud that merit mention. We point out that petitioner Albert Wedvik filed a Form W-4 on which he claimed seven additional withholding exemptions over the personal exemptions allowable for him and his wife. In light of the fact that he had to know that he made no charitable contributions that would significantly reduce his taxable income, filing a false Form W-4 is an indication of fraud. *Habersham-Bey v. Commissioner*, 78 T.C. 304, 313 (1982). Furthermore, despite claiming nine withholding exemptions, petitioners continued to receive large tax refunds in the taxable years in issue. This fact takes on added significance when we consider that if petitioner Albert Wedvik had claimed 10 or more withholding exemptions, thereby reducing the amount of tax withheld from his wages, his employer would have been required to report such fact to the IRS. Sec. 31.3402(f)(2)-1(g)(1)(i), Employment Tax Regs. (prior to amendment by T.D. 7803 (January 21, 1982)). Clearly, petitioners did not want to invite such scrutiny from the IRS.

Lastly, we point out that petitioners refused to produce the bank records requested by the revenue agent. Subsequently, petitioners filed a petition to quash a summons that had been served on the bank where petitioners maintained their personal and church checking accounts. The petition to quash asserted, among other things, that the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 324, was unconstitutionally enacted. Inasmuch as these bank records were essential to the discovery of the check-swapping schemes, we think that the refusal to produce those records, along with the unsuccessful attempt to quash the summons of those records, reasonably leads to the conclusion that these were further efforts to conceal the fact that petitioners were not entitled to the claimed charitable contribution deductions.

Because we uphold the determination of the Commissioner with respect to additions to tax for fraud under section 6653(b), we need not consider respondent's alternative allegation that petitioners are liable for additions to tax under section 6653(a), and for damages under section 6673.

Based upon the foregoing,

Decision will be entered for the respondent.

SIDNEY J. GEFEN AND LOIS I. GEFEN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 18900-82. Filed December 30, 1986.

Petitioner-wife invested in a limited partnership that purchased and leased computer equipment. She also executed a limited partner guarantee by which she assumed personal liability for her pro rata share of the partnership's recourse indebtedness. *Held*, the partnership's transactions were supported by economic substance. *Held, further*, the partnership's purchase and lease of the computer equipment were activities that were engaged in for profit. *Held, further*, petitioner-wife was entitled to include in her partnership basis her pro rata share of the partnership's recourse and nonrecourse liabilities. *Held, further*, petitioner-wife was at risk within the meaning of sec. 465, I.R.C. 1954, for her pro rata share of the partnership's recourse indebtedness.

Daniel S. Abrams and *Gerald A. Rosenberg*, for the petitioners.

Marwin A. Batt, *Roland Barral*, and *Robert A. Wagner*, for the respondent.

STERRETT, *Chief Judge*: By notice of deficiency dated April 27, 1982, respondent determined deficiencies in petitioners' Federal income taxes for the calendar years 1977, 1978, and 1979 in the amounts of $10,513.66, $8,376.65, and $9,420.60, respectively. By amendment to his answer, respondent alleged that the correct deficiency for 1977 is $10,479.00, and that the deficiencies for 1978 and 1979 should be increased in the amounts of $7,692.35 and $1,546.40, respectively. The deficiencies resulted from respondent's determination that petitioners were not entitled to deduct losses and interest expenses attributable to an investment by petitioner Lois I. Gefen in a limited partnership. After concessions, the issues for decision are (1) whether the partnership's transactions were supported by economic substance; (2) whether the partnership was engaged in an activity for profit; (3) whether petitioner Lois I. Gefen was entitled to include in her partnership basis her allocable share of partnership liabilities; and (4) whether petitioner Lois I. Gefen was at risk within the meaning of section 465[1] for her allocable share of the partnership' recourse indebtedness.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found The stipulation of facts and exhibits attached thereto ar incorporated herein by this reference.

Petitioners Sidney J. Gefen and Lois I. Gefen ar husband and wife. At the time the petition was filed in thi case, they resided in Jacksonville, Florida. Their join Federal income tax returns for the years in question wer filed with the Office of the Internal Revenue Service ir Atlanta, Georgia.

The Partnership

Dartmouth Associates (the partnership) was formed ir 1976 by Integrated Resources, Inc. (Integrated), as a limited partnership under the Uniform Limited Partnership Act of the State of Connecticut.[2] Integrated formed the partnership in order to have a partnership available for investment in real estate. The partnership's limited partnership agreement and certificate of formation of limited partnership were amended on or before July 27, 1977, to permit the partnership to enter into the trade and business of owning and leasing computer equipment.

The general partners of the partnership were IR-Oak Corp. (IR-Oak), a wholly owned subsidiary of Integrated, and Bernard Kaplan, the president of Underwriters' Service Agency, Inc., also a wholly owned subsidiary of Integrated. IR-Oak and Bernard Kaplan contributed in cash $5,060 and $506, respectively, as their capital contributions to the partnership. Donald Olsen, the initial limited partner, contributed in cash $506 as his capital contribution to the partnership.

In July of 1977, the partnership acquired, and commenced the business of owning and leasing, computer equipment.

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[1] Unless otherwise indicated, all sections referred to are sections of the Internal Revenue Code of 1954 as amended and in effect during the years in question, and all Rules referred to are Rules of the Tax Court Rules of Practice and Procedure.

[2] Integrated Resources, Inc., is a publicly owned corporation with shares traded on the New York Stock Exchange. Its primary lines of business are the structuring, marketing, and managing of investments for investors and the underwriting of insurance.

The equipment was manufactured by the International Business Machines Corp. (IBM), and was designated by IBM and known generally as a System 370 Model 168 computer. The partnership's gross income and deductions were derived principally from owning and leasing this computer equipment.

Commencing in September of 1977, the partnership distributed a confidential private placement memorandum (the confidential memorandum) and offered for sale to a limited number of qualified investors limited partnership interests aggregating a 98.8-percent interest in the partnership. Pursuant to this offering, the limited partners, other than the initial limited partner, contributed $499,928 as their aggregate capital contribution to the partnership.

The confidential memorandum stated that the partnership's investment objectives were the potential increase in equity in the computer equipment through the amortization of loans used to purchase the equipment; a small, net cash-flow during the term of the computer lease; a profit from the re-lease or sale of the equipment at the expiration of the lease, and current tax benefits. The confidential memorandum also contained discussions of the general economic, legal, and tax consequences of both the partnership's activities and an investment in the partnership.

Schedule A of the confidential memorandum projected that the partnership's investment in the computer equipment would generate tax losses in the early years of the investment but that, beginning in 1982, substantial taxable income would result, even though little net cash-flow was expected from the computer lease and even if the computer equipment had no value at the expiration of the lease.

Schedule B of the confidential memorandum projected the cumulative economic effects, after tax, of an investment in the partnership for investors in tax brackets of 55, 60, and 70 percent, using values of the computer equipment at the expiration of the lease of 0, 10, 16, 25, 30, and 40 percent of the equipment's original cost. This schedule indicated that an investor's return was dependent on the value of the computer equipment at the expiration of the lease (the residual value), and that an investor could expect an economic benefit from an investment in the partnership, after tax, if the computer equipment retained a value of at least 16 percent of the equipment's original cost. Although the confidential memorandum provided no assurance that the computer equipment would have any residual value, it contained an appraisal of the equipment by an independent appraiser that stated that it was reasonable to expect that the equipment would have a value in excess of $745,000 at the expiration of the lease. Schedules A and B of the confidential memorandum appear in Appendix A attached hereto.

The partnership reported its income and expenses on the accrual method of accounting and used the calendar year as its taxable year. The partnership's books and business records consisted of checking account statements, checkbook stubs, accountant workpapers, and annual financial statements.

Petitioner's Interest in the Partnership, the Limited Partner Guarantee, and Petitioner's Obligation To Make Additional Contributions to the Partnership

Petitioner Lois I. Gefen (petitioner) acquired her interest in the partnership by paying $24,996.50 (4.94 percent of the partnership's aggregate capital contributions) in cash to the partnership in October of 1977. She was a limited partner in the partnership on December 31 of each of the partnership taxable years 1977 through 1983. At all times relevant to this proceeding, she had a 4.94-percent interest in the partnership's capital, profits, and losses.

As a condition to her admission to the partnership as a limited partner, petitioner was required to and did execute and deliver to the partnership a limited partner guarantee (the guarantee). The guarantee stated that petitioner assumed personal liability for her pro rata share (4.94 percent) of the partnership's recourse indebtedness of $1,030,000. In pertinent part, the guarantee reads as follows:

> *Dartmouth Associates Limited Partner Guarantee*
>
> WHEREAS, the undersigned is a limited partner of Dartmouth Associates, a Connecticut limited partnership (the "Partnership") and
>
> WHEREAS, The Partnership is personally liable under certain circumstances to Sun Life Insurance Company of America (the "Lender") for an aggregate amount of $1,030,000 (the "Recourse Amount") under the

terms, and subject to the conditions and limitations, of Section 5 of a Security and Loan Agreement (the "Loan Agreement"), dated as of June 15, 1977, as amended, between the Lender and the Partnership, such Recourse Amount constituting a portion of the indebtedness of the Partnership under the Loan Agreement.

WHEREAS, each of the limited partners (the "Limited Partners") of the Partnership, as a condition to their admission as Limited Partners, are required by the Partnership personally to guaranty a pro rata portion of the Recourse Amount.

NOW, THEREFORE, in consideration of the premises and for other good and valuable consideration, receipt of which is hereby acknowledged and subject to the conditions set forth below, *the undersigned assumes personal liability for repayment of a portion of the Recourse Amount* and guarantees to the Lender as follows:

1. Subject to the provisions of, and conditions and limitations set forth in, Paragraph 4 below, Section 5 of the Loan Agreement and Section 5(c) of the Limited Partnership Agreement (the "Partnership Agreement") of the Partnership, the undersigned hereby *unconditionally guarantees to the Lender, its successors and assigns, the due and prompt collection, in accordance with the terms thereof,* of up to $101,764 of the Recourse Amount per Unit of Limited Partnership Interest in the Partnership purchased by the undersigned.

2. This undertaking shall operate as a continuing guarantee and shall remain in full force and effect until January 1, 1982. *The undersigned's obligation hereunder is not contingent upon similar undertakings by other Limited Partners.* The Lender may demand the undersigned's performance in whole or in part without regard to the undersigned's rights against co-guarantors, but in any event, the undersigned shall not be obligated for more than the product of (a) that portion of the Recourse Amount demanded by the Lender at the time of default and (b) the undersigned's percentage interest in the profits and losses of the Partnership. * * *

* * * * * *

4. *If the assets of the Partnership securing the Recourse Amount pursuant to the terms of the Loan Agreement shall not be sufficient to repay the Recourse Amount to the Lender, when due, then, and in such event, the undersigned agrees to make additional capital contributions to the Partnership, subject, as to the time and amount thereof, to the provisions of paragraphs 1 and 2 hereof and in accordance with Section 5(c) of the Partnership Agreement. The obligations of the undersigned to make additional capital contributions shall not in any way derogate from the right of the Lender to proceed to enforce this Guarantee directly against the undersigned without first proceeding against the Partnership.* It is understood and agreed that the obligation of the undersigned hereunder and under the Partnership Agreement shall be limited to any deficiency remaining with respect to the Recourse Amount after the Lender shall have exhausted all its rights, powers and remedies under the Loan Agreement with respect to the assets of the Partnership initially

> securing the Recourse Amount. In addition, the aggregate of the amou of additional capital contributions the undersigned shall be obligated make and any amounts paid by the undersigned hereunder directly to t Lender shall in no event exceed the undersigned's proportionate share the Recourse Amount based upon the undersigned's share of profits a losses in the Partnership. * * *
>
> * * * * * * *
>
> 6. The undersigned hereby authorizes the General Partners of t Partnership to act for and on behalf of the undersigned in all dealing with the Lender and the co-guarantors and acknowledges that t General Partners of the Partnership may act for the Lender co-guarantors in enforcing the obligations of the undersigned. In th event the undersigned defaults in the payment of his obligation hereunder, the General Partners may, institute legal action to enforc such payment, and the undersigned hereby pledges to the Genera Partners his right to all Partnership distributions after the date of suc default as security for payment of his obligations hereunder.
>
> [Emphasis added.]

Petitioner also was obligated under section 5(c) of the amended and restated limited partnership agreement (the limited partnership agreement) to make a special contribution to the partnership under certain circumstances. Section 5(c) of the limited partnership agreement reads as follows:

> (c) The Special Contribution of each Partner signatory to the counterpart of this Agreement shall be as specified in the Schedule of Partners' Contributions attached to this counterpart and shall be made by each such Partner pursuant to special calls therefor made on or before January 1, 1982 by the General Partner, such calls not to exceed, in any event, an aggregate amount equal to the product of such Partners's [sic] Distribution Percentage and $1,030,000. All Special Contributions by a Limited Partner shall be subject to the conditions and limitations of, and shall be in accordance with, the provisions of a certain Limited Partner Guarantee executed by such Limited Partner and a certain Security and Loan Agreement, dated as of June 15, 1977, between the Partnership and Sun Life Insurance Company of America, as amended.

Relevant portions of both the security and loan agreement, dated June 15, 1977, between the partnership and Sun Life, and the amendment to this agreement, appear in Appendix B attached hereto.

Under the terms of the limited partnership agreement, petitioner had no right to reimbursement from either the partnership or the general partners for amounts paid by her to the partnership as a special contribution or to Sun Life pursuant to the limited partner guarantee. Section 6(f) of the limited partnership agreement provided that limited partners had no right to withdraw or reduce their special contributions to the partnership once made, and section 7(d) of the limited partnership agreement provided that the general partners were not liable to the limited partners for any loss or liability incurred in connection with any matter, except for losses or liabilities attributable to the willful misconduct or gross negligence of a general partner.

Integrated's Decision To Enter the Computer Leasing Business

In the early spring of 1977, Stephen Goldsmith (Goldsmith), an employee of Integrated and later a vice president of IR-Oak, undertook a review of the computer leasing business on behalf of Integrated. Goldsmith's review included an analysis of recognized sources of historical computer industry information; a review of mass circulation business publications; discussions with Thomas McArdle (McArdle), the president of National Computer Rental (NCR), a computer leasing company; and a review of NCR's internal accounting and business records.

As a result of his investigation, Goldsmith discovered that in 1977, the Computer Price Guide, an authoritative source of information regarding selling prices of used computers, indicated that 12-year-old IBM 360 series computers, which were similar to but older than and not as advanced as the computer that was acquired by the partnership, were selling for prices as high as 25 percent of their initial cost. Goldsmith also discovered that NCR had a significant portfolio of IBM 360 series computers that were still under lease and generating significant revenue, and that in some cases, NCR was receiving in 1977 annual rent on its 360 series equipment equal to 25 percent of the annual rent it had received on the same equipment 12 years earlier. Goldsmith also was aware in 1977 that there were pessimistic predictions about the future of the used computer market, but he dismissed these predictions because he believed that they were too extreme.

Goldsmith decided that it was possible to make a profit in the computer leasing business and he presented the results of his investigation to the president of Integrated.

On the basis of the Goldsmith study, Integrated decided that it would participate in the computer leasing business either by investing for its own account or by sponsoring investment programs through limited partnerships.

Origin of the Partnership's Transactions

In 1977, Exxon Corp. (Exxon) was leasing an IBM System 370 Model 168 central processing unit and related peripheral equipment from IBM for approximately $90,000 per month. The equipment had been installed by IBM, pursuant to the lease, at an Exxon facility located in Florham Park, New Jersey.

Exxon wanted to purchase the equipment from IBM, sell it to a purchaser-lessor, and lease it back. Such a transaction would enable Exxon, without making any capital investment, to lease the equipment for a longer term and smaller monthly payments than under its lease from IBM. Exxon solicited bids to assist it in structuring and implementing such a transaction, and it received bids from approximately six companies, including American Computer Sales & Leasing (ACSL), a broker of used computer equipment. Exxon accepted ACSL's bid.

Harry Ault (Ault), the founder of ACSL, approached McArdle and Goldsmith to see if their respective companies, NCR and Integrated, would be interested in participating in the Exxon transaction (the transaction). Ault first approached McArdle because he knew that NCR had an insurance policy from Lloyd's of London that would, in effect, guarantee the residual value of computer equipment in a computer leasing transaction, and thereby make it possible to obtain financing for such a transaction. McArdle in turn introduced Ault to Goldsmith.

Ault proposed that NCR purchase the computer equipment from Exxon, sell it to Integrated, lease it back from Integrated, and then sublease the equipment to Exxon.[3] It was anticipated that Exxon would be the end user of the equipment; NCR would provide the expertise and skills necessary to coordinate and complete the transaction and, by reason of its insurance policy with Lloyd's of London, make financing possible; Integrated would own the equipment and provide the equity funds necessary to acquire it; and ACSL, in addition to bringing the parties together and facilitating negotiations, would remarket the equipment at the expiration of the leases. It was believed that the transaction would benefit the parties in the following ways: Exxon would reduce significantly its monthly rental payments for the equipment; NCR would earn a profit by selling the equipment to Integrated and also earn significant net cash-flow during the term of the lease to Exxon; Integrated would receive a small net cash-flow during the term of the lease to NCR, a profit from re-leasing or selling the equipment at the expiration of the lease, and current tax benefits; and ACSL would receive, in addition to a transaction fee, a portion of the proceeds from remarketing the equipment at the expiration of the lease.

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[3] A diagram of the completed transaction appears in Appendix C.

Some of the negotiations with respect to the transaction took place before Integrated had decided whether it would participate in the transaction by investing for its own account or through an investment vehicle. Ultimately, Integrated decided that it would sponsor a limited partnership to participate in the transaction, and it decided that the partnership would be that limited partnership.

Acting on behalf of Integrated and later on behalf of the partnership, Goldsmith negotiated the terms of the transaction. In addition to negotiating the purchase price of the equipment, the term of the lease to NCR, the amount of rent to be paid by NCR, and the interest rate that would have to be paid to the lender, Goldsmith negotiated the terms of the remarketing agreement with Ault. Goldsmith rejected Ault's proposal that ACSL be given the exclusive right, with no time limit, to remarket the computer equipment upon the expiration of the lease. Instead, Goldsmith insisted that ACSL be given only 180 days to remarket the equipment. Goldsmith also insisted that the partnership's share of the remarketing proceeds be increased from 11 percent to 16 percent of the equipment's cost, and he requested that an appraisal of the computer equipment be prepared by an outside professional appraiser.[4] The negotiations over the terms of the transaction sometimes went late into the night. Legal opinions also were obtained which assured the parties that the agreements were legal and enforceable under applicable non-tax laws. During the years in question, IBM, Exxon, Integrated, ACSL, and NCR were unrelated independent corporations.

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[4] The appraisal was prepared on or before Sept. 21, 1977, by Harvey N. Berlent, and was attached as an exhibit to the confidential memorandum. The appraisal stated that the fair

The Partnership's Acquisition of the Computer Equipment

The partnership acquired the computer equipment in two stages. The central processing unit and related peripheral equipment (the initial computer equipment) were acquired by the partnership on July 29, 1977. On September 1, 1977, the partnership acquired additional equipment (the upgrade) to expand the memory capacity of the initial computer equipment.

Initial Acquisition Stage

On July 29, 1977, Exxon terminated its lease with IBM and purchased the initial computer equipment for $3,100,043. This price included a purchase credit from IBM.[5] On the same day, NCR purchased the initial computer equipment from Exxon for $3,146,430, and sold it to the partnership for $3,331,022.

NCR paid $46,387 to Exxon in connection with its purchase of the initial computer equipment. This amount represented the difference between the amount paid by Exxon for the initial computer equipment ($3,100,043) and the amount paid by NCR ($3,146,430), and it compensated Exxon for costs incurred as a result of a delay in completing the transaction.

The partnership paid for the initial computer equipment by wiring funds in the amount of $2,955,671.47 from Sun Life Insurance Co. of America (Sun Life), the partnership's lender, to IBM, and by issuing checks to IBM and NCR in the amounts of $144,371.53 and $230,979, respectively.

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market value of the partnership's equipment at the time the appraisal was prepared was $3,710,000, and that it was reasonable to expect that in July of 1984, the equipment would have a value in excess of $745,000.

[5] The precise amount of the purchase credit does not appear in the record.

Second Acquisition Stage

On September 1, 1977, NCR purchased the upgrade from IBM for $235,000 and sold it to the partnership for $258,672. The partnership paid for the upgrade by wiring funds from Sun Life to IBM in the amount of $230,005.21, and by issuing checks to IBM and NCR in the amounts of $4,994.79 and $23,672, respectively.

Miscellaneous Costs

The partnership paid to Arlington Leasing, Inc. (Arlington), a wholly owned subsidiary of Integrated, a fee of $119,405 for services rendered by Arlington in connection with the acquisition of the initial computer equipment and the upgrade (the computer equipment). Arlington was an equipment leasing company that Integrated acquired in August of 1977, and it provided advice to Integrated and IR-Oak, the general partner of the partnership, on how to negotiate and close equipment leasing transactions. The partnership treated the fee as an acquisition cost and included it in its cost basis of the computer equipment.[6]

The partnership also paid (a) selling commissions in the aggregate amount of $29,995.68 to Kelley & Morey, Inc. (Kelly & Morey), a wholly owned subsidiary of Integrated, for services in connection with selling limited partnership interests in the partnership; (b) interim interest in the amount of $1,518.89 to Manufacturers Hanover Trust Co. for a short term loan; and (c) a fee of $10,000 to a law firm for tax advice.

The Partnership's Financing of the Computer Equipment

Pursuant to a security and loan agreement dated June 15, 1977 (the loan agreement), the partnership obtained from Sun Life a loan in the principal amount of $2,955,671.47 (the initial loan) for the purpose of financing its purchase of the initial computer equipment. The partnership evidenced its obligation to repay the initial loan by executing and delivering to Sun Life a promissory note, dated July 29,

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[6] The partnership reported on its Federal income tax returns (Forms 1065) a total cost basis for the computer equipment of $3,709,099, consisting of the purchase price of $3,589,694 plus the $119,405 fee paid to Arlington.

1977 (the partnership note). The principal amount of the initial loan together with interest at a rate of 9.25 percent per annum was repayable by the partnership in 83 consecutive monthly installments, commencing on September 1, 1977, in the amount of $51,524.79 for the first 35 months and $45,157 for the subsequent 48 months. Section 5 of the loan agreement provided that the partnership was personally liable for the repayment of $975,000 of the initial loan.[7]

To provide financing for its purchase of the upgrade, the partnership borrowed from Sun Life an additional amount of $230,005.21 (the additional loan). The partnership and Sun Life amended the loan agreement to reflect the additional loan. The partnership evidenced its obligation to repay the additional loan by executing and delivering to Sun Life a promissory note dated September 1, 1977 (the upgrade note). Payments on the upgrade note commenced on October 1, 1977. The amendment to the security and loan agreement and the upgrade note provided that the partnership was personally liable for the repayment of $55,000 of the additional loan.

The aggregate principal amount of the initial loan and the additional loan (the loans) in the amount of $3,185,676.68 was repayable in accordance with the loan agreement, as amended. After the partnership's initial installment payment on September 1, 1977, of $51,524.79, the loans were repayable by the partnership in 82 consecutive monthly installments of $55,403.79 for the first 34 months and $48,870 for the subsequent 48 months. According to the amendment to the security and loan agreement, the aggregate portion of the loans for which the partnership was personally liable was $1,030,000. Financing statements were filed reflecting the partnership as the owner of the computer equipment and the borrower on the Sun Life loans.

The Partnership's Lease to NCR and NCR's Lease to Exxon

On July 29, 1977, the partnership leased the initial computer equipment to NCR for a term of 84 months (the computer lease). On September 1, 1977, the partnership leased the upgrade to NCR, pursuant to an amendment to the computer lease, for the remaining term of the computer lease.

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[7] See Appendix B at page 1508.

The computer lease was a net lease, which required NCR to maintain the computer equipment, keep it insured, and pay all fees and taxes with respect to the computer equipment. NCR had no right to terminate the computer lease, no option or obligation to purchase or re-lease the computer equipment at the expiration of the computer lease, and was required to deliver the computer equipment to the partnership at the expiration of the computer lease.

The rent payable by NCR to the partnership under the computer lease, as amended, was as follows: interim rent in the amount of $3,440.32 for the period from the commencement of the computer lease through July 30, 1977; monthly installments of $51,604.79 payable on August 1, 1977, and September 1, 1977; and (following the addition of the upgrade to the computer lease) $55,575.79 payable on the first day of each month in advance commencing on October 1, 1977, for the first 35 months and $48,965 for the subsequent 48 months. These amounts were sufficient to enable the partnership to pay the debt service due under the loans (which would be fully paid off at the expiration of the computer lease), pay its expenses, and make small cash distributions to its partners during the term of the computer lease.

On July 29, 1977, NCR subleased the initial computer equipment to Exxon for a term of 84 months (the Exxon lease). On September 1, 1977, NCR subleased the upgrade to Exxon pursuant to an amendment to the Exxon lease. Exxon had the right to terminate the Exxon lease at the expiration of the 36th month or at any time thereafter. The Exxon lease also was a net lease.

The rent payable by Exxon to NCR under the Exxon lease, as amended, was as follows: interim rent in the amount of $4,202 for the period from the commencement of the Exxon lease through July 30, 1977; $63,030 payable on August 1, 1977, and September 1, 1977; $3,894 payable as interim rent for the period from the addition of the upgrade to the Exxon lease through September 30, 1977; $67,894 payable on the first day of each month, in advance, commencing on October 1, 1977, for 35 months and $52,548 for the subsequent 48 months.

On July 29, 1977, with Exxon's consent, NCR assigned to the partnership, as collateral, security for NCR's obligations to the partnership under the computer lease, NCR's right, title, and interest (but none of its obligations) as lessor in the Exxon lease.[8] The assignment and consent were amended on September 1, 1977, to reflect the acquisition and lease of the upgrade.

To further secure its rental payment obligations under the computer lease, NCR agreed to set aside, in an escrow account, $11,425.21 per month out of the Exxon lease payments it was due for the initial 36 months of the computer lease. The escrow agreement was amended on September 1, 1977, to reflect the addition of the upgrade to the computer lease and the Exxon lease, and the set-aside amount was increased to $12,395.21.

NCR also purchased for itself a computer lease indemnity policy from Lloyd's of London, dated September 1, 1977, and attaching May 1, 1977, which named NCR, but not the partnership or petitioner, as the insured, and Sun Life as an additional insured. The amount insured was $1,880,256 (following an increase of $143,155 as a result of the lease of the upgrade), which amount approximated 80 percent of NCR's remaining rental obligation to the partnership after the initial 36 months of the computer lease. Under the terms of the policy, Lloyd's of London agreed to pay up to 80 percent of NCR's obligation under the computer lease if Exxon terminated the Exxon lease on or after August 1, 1980. NCR paid approximately $40,000 for this insurance.

On January 31, 1980, Exxon elected to terminate the Exxon lease. Exxon and NCR thereupon negotiated an extension of the Exxon lease for an additional 18 months at a reduced rental.

In March of 1983, NCR discontinued making rental payments under the computer lease and was, and as of the date of trial continued to be, in default thereunder. As a result, in 1983, Lloyd's of London paid $775,863 to Sun Life in accordance with the computer lease indemnity policy referred to above.

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[8] Exxon also agreed to make all payments due under the Exxon lease directly to Sun Life.

The Partnership's Initial Sources and Uses of Funds in 1977

The partnership's initial sources and uses of funds in 1977 were as follows:

Sources of funds		
Capital contributions		$506,000
Contributions of the general partners	$5,566	
Contributions of the initial limited partner	506	
Contributions of the investor limited partners	499,928	
Loans		3,185,676
Recourse portion	$1,030,000	
Nonrecourse portion	2,155,676	
Advance rental payment from NCR		55,498
Interim rental payment from NCR		3,440
Total		3,750,614
Uses of funds		
Acquisition of computer equipment		3,589,694
Initial computer equipment	$3,331,022	
Upgrade	258,672	
Acquisition fee		119,405
Selling commissions		29,996
Interim interest		1,519
Fee for tax advice		10,000
Total		3,750,614

The Remarketing Agreement

To provide for the sale or re-lease of the computer equipment at the expiration of the computer lease, the partnership entered into a remarketing agreement with ACSL dated September 1, 1977, appointing ACSL as the partnership's exclusive agent for remarketing the computer equipment. Under the terms of this agreement, ACSL was obligated to exercise its best efforts to sell or re-lease the computer equipment on behalf of the partnership.

ACSL had 180 days to sell or re-lease the computer equipment, or demonstrate satisfactory prospects for selling or re-leasing the computer equipment, in order to retain its exclusive agency with the partnership. If the computer equipment was remarketed after the 180-day period by a party other than ACSL, ACSL would not have been entitled to any compensation.

ACSL had no authority to bind or otherwise obligate the partnership to any sale, lease, or other disposition of the computer equipment. In the event of a sale, re-lease, or other disposition of the computer equipment under the remarketing agreement, all of the proceeds were first to be distributed to the partnership until the partnership received an amount equal to 16 percent of the partnership's initial cost of acquiring the computer equipment from NCR, and any amount in excess of this amount was to be distributed 50 percent to the partnership, 25 percent to ACSL, and 25 percent to Arlington.

Residual Value

The partnership's computer equipment had virtually no moving parts that wear with age; instead, it was composed of electronic integrated circuits that frequently improve as they are used. As a result, the value of such equipment depends not on its physical age but on technological advancements. As new, more advanced computer equipment is introduced, the market gradually loses interest in older equipment. Eventually, only a few users are interested in the older equipment even at very low prices.

During the years in question, the primary factor that influenced prices for used IBM computer equipment was IBM's own new products. IBM announcements about new products or price changes usually had an immediate impact on the market values of used IBM computers.

In the early 1960's, IBM introduced the IBM 360 series of computers. This product line was a dramatic departure from its previous computers in that it combined into a single family what had been previously a conglomeration of several different models. The 360 series was so popular that IBM felt no need to introduce its next generation of computers, the 370 series, until 1971.

The 360 series was not without disadvantages, however. Extraordinary efforts were required to convert a computer user's operations to the 360 series. This in turn made it possible for competitors of IBM to wage strong, but largely unsuccessful, campaigns to persuade computer users to abandon IBM products. While the 360 series offered clear advantages over earlier generations of equipment, IBM and computer users discovered that converting from one computer system to a vastly different one was a difficult and costly task.

In 1971, IBM introduced the first models of the 370 series of computers, which offered only modest improvements over the 360 series. The IBM System 370 Model 168, the same model that was acquired and leased by the partnership, was announced in 1972 as the successor to an earlier model of the 370 series and was first installed in the summer of 1973. It was a high-end virtual storage machine that provided cost savings and operational advantages over its predecessor and became popular with very large advanced users.

In the early 1970's, it became generally known that IBM intended to develop and implement a new "Future System" (FS) of computer equipment. FS was expected to be another dramatic departure from earlier IBM families of computers, in the same way that the 360 series had been. By 1975, however, it became clear that IBM had abandoned FS, and in October of 1976, IBM publicly announced that future changes in its products would be "evolutionary" rather than "revolutionary." The demise of FS had the effect of increasing the market values of used IBM products in 1975 and 1976.

In January of 1979, IBM announced the 4300 series of computers. The 4300 series was much less expensive than its predecessors, offered dramatically superior performance, and was completely unexpected by the industry. As a result, it had a devastating effect on the residual values of earlier IBM computers, including the System 370 Model 168.

The partnership's income, expenses, and net loss for the years 1977-83 were reported on its Federal income tax returns (Forms 1065) as follows:

	1977	*1978*	*1979*
Gross rental income	$277,040	$665,986	$665,985
Interest income	9,552	16,567	7,629
Depreciation	(569,729)	(963,193)	(672,120)
Interest expense	(129,749)	(280,229)	(232,567)
Other expense	(10,017)	(500)	(502)
Net gain or (loss)	(422,903)	(561,369)	(231,575)

	1980	*1981*	*1982*	*1983*
Gross rental income	$633,317	$587,580	$587,580	$873,793
Interest income	2,482	148	67	. . .
Depreciation	(610,636)	(610,636)	(308,537)	(6,438)
Interest expense	(185,721)	(143,333)	(100,467)	(6,309)
Other expense	(750)	(4,597)	(1,015)	(8,977)
Net gain or (loss)	(161,308)	(170,838)	177,628	852,069

	1977-1983
Cumulative net gain or (loss)	($518,296)

Petitioner reported and deducted her distributive share of partnership losses and interest expenses for the years in question on her corresponding Federal income tax returns. In his notice of deficiency, respondent disallowed these deductions, stating that "it has not been established that any deductible loss was sustained by the partnership during the taxable year."

Ultimate Findings of Fact

The partnership purchased and leased the computer equipment with the predominant purpose and intention of making a profit. The partnership's transactions were motivated by business purpose and were bona fide arm's-length transactions at fair market value from which the partnership could reasonably have expected to derive an economic profit exclusive of tax benefits.

OPINION

We must decide whether petitioner is entitled to deduct her distributive share of partnership losses and interest expenses for the years in question. Petitioner bears the burden of proof with respect to the original deficiencies, and respondent bears the burden of proof with respect to the increased deficiencies in the amended answer. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Reiff v. Commissioner*, 77 T.C. 1169, 1173 (1981).

Respondent's basic position in this case is that the partnership's ownership of the computer equipment should be disregarded for tax purposes because the computer leasing transaction was a tax-avoidance scheme totally lacking in economic substance. In support of this position, respondent argues that the partnership never acquired the benefits and burdens of owning the computer equipment, the partnership never had an equity investment in the computer equipment, the partnership's purchase and lease of the computer equipment were not motivated by a valid business purpose and did not offer petitioners any potential for economic profit, and the partnership's transactions do not satisfy the tests of substance established by the Supreme Court in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). Respondent also argues that the partnership never was engaged in any activity for profit within the meaning of section 183, that petitioner never obtained a basis in her partnership interest that was greater than her cash contribution to the partnership, and that petitioner never was "at risk" within the meaning of section 465 for any amount in excess of her cash contribution to the partnership.[9]

Petitioner contends that the partnership's transactions should be recognized for tax purposes and that the partnership is entitled to all of the tax benefits afforded the owner of the computer equipment. She argues that the partnership's purchase and lease of the computer equipment were motivated by business purpose and supported by economic substance, that the partnership acquired the benefits and burdens of owning the computer equipment, and that the partnership had an equity investment in the computer equipment. Petitioner also asserts that she was entitled to include in her basis in her partnership interest her allocable share (4.94 percent) of the partnership's recourse and nonrecourse liabilities and that she was at risk within the meaning of section 465 for an amount sufficient to permit her to deduct her distributive share of partnership losses and interest expenses for each of the years in question. For the reasons set forth below, we find for petitioner.

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[9] Respondent also appears to question whether the partnership properly elected the half-year convention for depreciation, and he asserts that there is no indication in the record that the partnership kept the required records to allow for any depreciation prior to Dec. 29, 1977. The record discloses, however, that the partnership properly adopted the half-year convention on Form 4832 of its 1977 Partnership Return of Income (Form 1065), and that the partnership maintained complete documentation of its purchase and lease of the computer equipment.

Economic Substance

The fact that a transaction generates tax benefits for investors does not necessarily mean that the transaction lacks economic substance. *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 (1978); *Mukerji v. Commissioner*, 87 T.C. 926 (1986); *Estate of Thomas v. Commissioner*, 84 T.C. 412, 432 (1985). However, where a transaction is entered into without any purpose other than to obtain tax benefits, the form of the transaction will be disregarded and the tax benefits will be denied. *Law v. Commissioner*, 86 T.C. 1065, 1093 (1986); *Estate of Thomas v. Commissioner*, *supra* at 432-433. A transaction has economic substance and will be recognized for tax purposes if the transaction offers a reasonable opportunity for economic profit, that is, profit exclusive of tax benefits. *Estate of Thomas v. Commissioner*, *supra* at 438; *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 203 n. 17 (1983), affd. on this issue 752 F.2d 89 (4th Cir. 1985). We conclude that the partnership's purchase and lease of the computer equipment were supported by economic substance because the record in this case establishes that the partnership's transactions offered a reasonable opportunity for economic profit.

In July of 1977, the executives of Integrated, NCR, and ACSL who negotiated the partnership's transactions were familiar with computer equipment and computer leasing transactions. They also were familiar with the history of the computer industry and with projections of residual values of computer equipment, and they were aware that Lloyd's of London was willing to insure residual values of computer equipment in computer leasing transactions for a relatively small fee. As a result of their knowledge and experience, they believed in 1977 that the partnership's computer equipment would have a residual value in 1984 at the expiration of the computer lease in excess of 20 percent of the equipment's cost. They confirmed their belief by obtaining in 1977 an independent appraisal of the partnership's computer equipment that indicated that it would be reasonable to expect that the computer equipment would have a residual value in 1984 in excess of $745,000.

We find that in 1977, it was reasonable to believe that the partnership's computer equipment would have a residual value in 1984 in excess of 20 percent of its cost. The demise of IBM's "Future System" encouraged many to believe that IBM's new products would be compatible with the 370 series, and that the 370 series would therefore retain substantial residual value. Indeed, in October of 1976, IBM publicly announced that future changes in its product line would be "evolutionary" rather than "revolutionary." Moreover, the 360 series had in fact retained substantial residual value despite the introduction of the 370 series in 1971, and in 1977, 360 series computers were selling, in some cases, at prices as high as 25 percent of cost and were generating rental revenue as high as 40 percent of their original rent.

The fact that Lloyd's of London was willing, in effect, to guarantee the residual value of the partnership's computer equipment in July of 1977, for a relatively small premium, is strong evidence that it was not unreasonable to believe in July of 1977 that the partnership's computer equipment would have substantial residual value at the expiration of the computer lease in 1984.[10] The fact that the partnership's computer equipment ultimately had no value in 1984, due to unexpected actions by IBM in January of 1979, does not affect the reasonableness of predictions made and beliefs held in the summer of 1977. Tax consequences cannot depend on unrealistic demands for certainty. If the computer equipment had retained a residual value in 1984 of 20 percent of the equipment's cost, the partnership would have realized a pre-tax profit on its $506,000 investment of $140,145 plus $4,370 in projected cash-flow.[11] Because we conclude that in 1977 there was a reasonable possibility that the computer equipment would have a residual value in 1984 in excess of 20 percent of its cost, it follows that there was a reasonable possibility that the partnership's purchase and lease of the computer equipment would return a pre-tax profit in excess of $144,515. This potential for profit constitutes the requisite economic substance. See *James v. Commissioner*, 87 T.C. 905, 924 (1986); *Estate of Thomas v. Commissioner, supra* at 437; *Rice's Toyota World, Inc. v. Commissioner, supra* at 203 n. 17.

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[10] All but one of the experts who testified in this case concluded that in 1977 it would have been reasonable to believe that the partnership's computer equipment would have substantial residual value in 1984. Harvey Berlent, the president of Berlent Industries, Inc., a company involved in the purchase, sale, lease, and appraisal of computer equipment, testified for petitioner and concluded that in 1977, it would have been reasonable to assume that the partnership's computer equipment would have a value in 1984 in excess of 20 percent of the equipment's cost. Mr. Berlent prepared the appraisal of the partnership's computer equipment in 1977 and predicted in that appraisal that in 1984 the computer equipment would have a residual value in excess of $745,000.

Esmond Lyons, the director of the western regional office of SRI International (formerly known as the Stanford Research Institute), a not-for-profit corporation involved in technology research and management consulting, also testified for petitioner and concluded that in 1977 it would have been reasonable to believe that in 1984 the partnership's computer equipment would have a value in excess of 20 percent of its cost.

Frederic Withington, a vice president of Arthur D. Little, Inc., a consulting firm based in Cambridge, Massachusetts, testified for respondent and concluded, based on a report that he prepared in August of 1977, that he would have predicted in 1977 that the partnership's computer equipment would have a value in 1984 of between $275,000 and $549,000.

Only Dee Morgan, an expert witness for respondent and a former employee of the General Services Administration, testified that in 1977, she would have predicted that in 1984 the partnership's computer equipment would have no value. While Ms. Morgan's prediction, if she had made it in 1977, would have turned out to be correct, we note that she did not make her prediction in 1977, and that the only two experts who actually made predictions in 1977, Frederic Withington and Harvey Berlent, both predicted *in 1977* that the partnership's computer equipment (or equipment similar to it) would have substantial residual value in 1984.

In any event, the question is not who was correct in predicting the actual residual value of the computer equipment in 1984; rather, the question is what was reasonable to believe in 1977 with respect to what the residual value of the computer equipment would be in 1984. We are satisfied that the evidence in the record as a whole establishes that in 1977 it was reasonable to believe that the partnership's computer equipment would have a value in 1984 in excess of 20 percent of the equipment's cost.

Respondent's argument that the partnership never acquired the benefits and burdens of owning the computer equipment is without merit. The partnership acquired the most significant benefit and burden of owning the computer equipment, namely, the potential of realizing a profit or loss on the sale or re-lease of the computer equipment. See *Estate of Thomas v. Commissioner, supra* at 434; *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1238 (1981). Moreover, the partnership was personally liable under the security and loan agreement for a significant portion of the notes to Sun Life. The fact that the balance of the partnership's debt was nonrecourse and that the rental payments under the computer lease were just slightly more than the partnership's debt service are merely neutral

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[11]

$3,589,694 (Price paid by partnership for computer equipment) × 20% =	$717,939
Plus cash-flow projected in confidential memorandum	4,370
Less broker's fee of 50% of amount in excess of 16% of computer equipment's cost (50% of $143,588 ($717,939 − $574,351))	(71,794)
Less total amount invested by partnership	(506,000)
Total partnership profit	144,515

factors in determining the substance of a leasing transaction. See *Dunlap v. Commissioner*, 74 T.C. 1377, 1435-1436 (1980), revd. on another issue 670 F.2d 785 (8th Cir. 1982); *Hilton v. Commissioner*, 74 T.C. 305, 348, 363 (1980), affd. per curiam 671 F.2d 316 (9th Cir. 1982), cert. denied 459 U.S. 907 (1982). Moreover, we have long rejected any notion that a net lease, such as the computer lease in this case, shifts the burden of ownership from the lessor to the lessee. See *Estate of Thomas v. Commissioner*, *supra* at 433; *Hilton v. Commissioner*, *supra* at 348; *LTV Corp. v. Commissioner*, 63 T.C. 39, 49-50 (1974).

There also is no basis for concluding that the partnership did not have an equity investment in the computer equipment. The partnership acquired the computer equipment for a price equal to its fair market value at the time of purchase,[12] and the indebtedness to which the computer equipment was subject was less than the computer equipment's fair market value.[13] The partnership therefore had an equity investment in the computer equipment that it could not prudently abandon,[14] and the partnership's indebtedness was genuine. See *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976), affg. 64 T.C. 752 (1975); *Narver v. Commissioner*, 75 T.C. 53, 98-99 (1980), affd. per curiam 670 F.2d 855 (9th Cir. 1982).[15]

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[12] One expert witness testified for respondent that the fair market value of the computer equipment on July 28, 1977, was $3 million. Respondent's other expert witness testified that the fair market value of the computer equipment in August of 1977 was $3,109,742. We find neither of these estimates to be reliable.

Exxon purchased the initial computer equipment from IBM, *with purchase credits*, for $3,100,043 on July 29, 1977, and NCR purchased the Upgrade from IBM for $235,000 on Sept. 1, 1977. These were arm's-length transactions between unrelated parties.

"when a property is purchased as a result of good-faith arm's-length bargaining between unrelated parties, with neither buyer nor seller being under any compulsion and there being no special circumstances present, the purchase price will in general reflect the value of the article purchased at the time of purchase." [*Abramson v. Commissioner*, 86 T.C. 360, 372 (1986).]

Accordingly, we find that the fair market value of the computer equipment, without purchase credits, was *more than* $3,335,043 ($3,100,043 plus $235,000) in the summer of 1977. Moreover, because the partnership's purchase of the computer equipment from NCR was also an arm's-length transaction between unrelated parties, and the partnership's purchase price did not involve any purchase credits, we find that the fair market value of the computer equipment in the summer of 1977, without purchase credits, was the price the partnership paid for it, $3,589,694.

The partnership reported on its Federal income tax returns (Forms 1065) a total cost basis for the computer equipment of $3,709,099, consisting of the purchase price of $3,589,694 plus a fee of $119,405 paid to Arlington Leasing, Inc., for services rendered in connection with the acquisition of the computer equipment. Respondent does not argue that the amount of the fee paid to Arlington was unreasonable or that it was improper to include the fee as part of the cost basis of the computer equipment.

[13] The fair market value of the computer equipment at the time the partnership acquired it was $3,589,694, the price the partnership paid for it. See note 12 *supra*. The total amount of the indebtedness to which the computer equipment was subject was $3,185,676.68. Of this amount, $1,030,000 was recourse indebtedness and $2,155,676.68 was nonrecourse indebtedness. See Appendix B at pages 1508-1509.

Moreover, while it is true that the partnership's transactions offered investors tax savings in early years, in later years the depreciation and interest deductions were projected to be less than the income from the computer lease, and investors therefore would have to pay tax on the partnership's income. As a result, the projected net tax savings over the life of the partnership for a 70-percent taxpayer who invested $49,993 in the partnership (the amount necessary to purchase one limited partnership unit) were only $37,898.[16] We conclude from this that an investor could not have invested in the partnership solely for tax benefits.

We finally note that the form of the partnership's transactions matched their substance. The transactions entered into by the partnership were fully documented. The partnership was treated consistently as the owner of the computer equipment, as noted in the bills of sale from NCR, the security and loan agreement with Sun Life, the computer lease with NCR, and the remarketing agreement with ACSL. The parties to these transactions did not create transactional documents for the sole purpose of supporting claimed tax benefits. The negotiations over the documents centered on legitimate business and economic factors and sometimes went late into the night. Legal opinions were obtained to assure the parties that the agreements were legal and enforceable under applicable non-tax laws. Financing statements were filed reflecting the partnership as the owner of the computer equipment and the borrower on the Sun Life loan. Nothing in the record suggests that the partnership did not view its rights and obligations as real, and nothing suggests that the partnership merely "papered" a solely tax-motivated transaction. See *Falsetti v. Commissioner*, 85 T.C. 332, 347 (1985).

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[14] The partnership also had no incentive to abandon the computer equipment because it was personally liable to Sun Life for $1,030,000, and NCR was unconditionally obligated by the computer lease to make rental payments to the partnership during the computer lease in amounts sufficient to amortize the partnership's indebtedness to Sun Life.

[15] Respondent's contention that the partnership's indebtedness to Sun Life "was an illusion" and too contingent to be considered genuine finds no support in the record. The partnership and Sun Life entered into a security and loan agreement and the partnership executed promissory notes evidencing its indebtedness to Sun Life. Sun Life wired funds aggregating more than $3 million to IBM at the direction of the partnership. Moreover, the partnership was responsible for the monthly payments on its indebtedness to Sun Life regardless of whether the lessees paid their monthly rent or defaulted.

While it is true that Sun Life's loans were secured by Exxon's financial status, Sun Life's security interest in the computer equipment, and the Lloyd's of London insurance policy, this does not mean that the partnership's indebtedness to Sun Life was illusory or too contingent to be considered genuine. In leasing transactions, prudent businessmen will always seek lessees that are financially strong, and prudent lenders will always seek, if the risk inherent in the transaction demands it, a security interest in the property that is acquired with the borrowed funds. Moreover, the protection afforded to NCR (and arguably to the partnership) by the Lloyd's insurance policy was no different from the protection afforded to NCR by subleasing the computer equipment to a financially strong lessee such as Exxon.

Respondent would apparently have us hold that the indebtedness incurred by a lessor in a leasing transaction is genuine only if the lessee is financially weak and the lender does not have a security interest in the property that is acquired with the lender's funds. We decline to do so.

[16] See Schedule B in Appendix A at pages 1506-1507.

In *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978), the Supreme Court held that—

> where * * * there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

We hold that the partnership's transactions were genuine multiple-party transactions with economic substance that were encouraged by business realities, imbued with tax-independent considerations, and not shaped solely by tax-avoidance features with meaningless labels attached. Accordingly, the form of the partnership's transactions must be respected, and the partnership is entitled to all of the tax benefits afforded an owner of the computer equipment.

Activity for Profit

Respondent argues, however, that the partnership never was engaged in an activity for profit within the meaning of section 183. We disagree.

Section 183(a) provides the general rule that where an individual is engaged in an activity, and "if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section." Section 183(b)(1) provides that deductions which would be allowable without regard to whether such activity is engaged in for profit shall be allowed, and section 183(b)(2) provides that deductions which would be allowable only if such activity were engaged in for profit shall be allowed "only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1)."

In determining whether an investment by an individual in a limited partnership constitutes an activity for profit within the meaning of section 183, the issue must be determined at the partnership level on the basis of the activities of the partnership. *Hager v. Commissioner*, 76 T.C. 759, 781-783 (1981); see *Brannen v. Commissioner*, 78 T.C. 471, 501-505 (1982), affd. 722 F.2d 695 (11th Cir. 1984).[17] Thus, if a limited partnership is engaged in an activity for profit within the meaning of section 183, its limited partners are likewise engaged in an activity for profit, and deductions attributable to their investment in the partnership are not subject to the limitations of section 183.

Section 183(c) defines an activity not engaged in for profit as follows:

> SEC. 183(c). ACTIVITY NOT ENGAGED IN FOR PROFIT DEFINED.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

The question then is whether the partnership was engaged in an activity during the years in question that constituted a trade or business so that expenses incurred in connection with the activity were deductible under section 162.[18]

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[17] "This does not mean, however, that our inquiry is confined solely to the activities of the partnership, for those parties possessing resources sufficient to acquire and exploit investment property are not always blessed with corresponding expertise. In such case, a partnership can rely upon the expertise of third parties * * *. The scope of the relevant inquiry therefore expands to encompass the entirety of such multilayered transactions." *Flowers v. Commissioner*, 80 T.C. 914, 932 (1983).

[18] Petitioner does not argue that the partnership was engaged in an activity for the production of income under sec. 212. Since the partnership's deductions were taken as expenses incurred in a trade or business, and petitioner did not claim the deductions on her tax returns under sec. 212, we treat the question whether the partnership was engaged in an activity for profit as arising under sec. 162. See *Flowers v. Commissioner*, *supra* at 931 n. 23.

An activity is a trade or business for purposes of section 162 if it is carried on with the predominant purpose and intention of making a profit. *Abramson v. Commissioner*, 86 T.C. 360, 370 (1986); *Flowers v. Commissioner*, 80 T.C. 914, 931 (1983); *Siegel v. Commissioner*, 78 T.C. 659, 698 (1982). The expectation of profit need not be a reasonable one, but there must be a bona fide objective of realizing a profit. *Allen v. Commissioner*, 72 T.C. 28, 33 (1979). The issue of whether there is an intention to make a profit is one of fact to be resolved on the basis of all the facts and circumstances of the case, and the burden of proving the requisite intention is upon petitioner. *Abramson v. Commissioner*, *supra* at 370; *Flowers v. Commissioner*, *supra* at 931-932. Some of the factors that may be helpful in determining whether an activity is engaged in for profit are set forth in the regulations.[19] These factors are not applicable to every case, however, and a careful review of the facts and circumstances of each case remains the primary test. *Abramson v. Commissioner*, *supra* at 371.

On the record before us, we have no difficulty in concluding that the partnership purchased and leased the computer equipment with the predominant purpose and intention of making a profit. The record establishes not only that it was reasonably possible that the partnership's activities would return a substantial pre-tax profit to the partnership, but that those who represented the partnership worked hard to ensure that the partnership would in fact realize that profit.

Goldsmith, acting on behalf of Integrated and later on behalf of the partnership, made a substantial effort to analyze the computer leasing industry and the transactions to be entered into by the partnership. He reviewed the internal historical and accounting records of NCR with McArdle to determine NCR's experience with its equipment portfolio. This analysis indicated that 12-year-old computer equipment was generating annual rent in 1977 equal to 25 percent of the equipment's original annual rent. Goldsmith also subscribed to, and obtained back issues of, a number of computer publications. He found the information contained in these publications useful in corroborating the data provided by McArdle. After analyzing the data provided by NCR and the data available in the marketplace, Goldsmith believed that the partnership's purchase and lease of the computer equipment presented a reasonable potential for a significant profit.

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[19] See sec. 1.183-2(b), Income Tax Regs.

Goldsmith also endeavored to negotiate the terms of the partnership's transactions to the partnership's best advantage. The terms were the subject of arm's-length negotiations between Goldsmith and Ault or McArdle. Substantial negotiations took place with respect to the purchase price of the computer equipment, the terms of the loan from Sun Life, and the remarketing agreement. Believing that the residual value of the computer equipment at the expiration of the computer lease would be at least 20 percent of the equipment's cost to the partnership, Goldsmith insisted that the partnership's initial share of any remarketing proceeds be raised from 11 percent to 16 percent of the computer equipment's original cost. Goldsmith also insisted that ACSL's right to remarket the computer equipment be limited in time to 180 days. Goldsmith's negotiations with Sun Life with respect to the security and loan agreement went far into the night. In sum, Goldsmith seriously evaluated the computer leasing industry and the profit to be made from the partnership's transactions, and he worked hard to obtain terms favorable to the partnership. Such facts demonstrate that Goldsmith, and therefore the partnership, were interested primarily in the business, non-tax aspects of the partnership's transactions.

Respondent asserts, however, that the projected tax benefits from the partnership's activities were far greater than any reasonable potential for profit and that such a disparity indicates that the partnership's activities were not engaged in for profit. We agree with respondent that a disparity between projected tax benefits and pre-tax profits is a factor to be considered in determining whether an activity is engaged in for profit within the meaning of section 183. See *Estate of Baron v. Commissioner*, 83 T.C. 542, 557-558 (1984), affd. 798 F.2d 65 (2d Cir. 1986). However, we disagree with respondent that the record establishes that such a disparity existed in this case. To the contrary, because the record establishes that the partnership's activities presented a reasonable opportunity for very substantial pre-tax profits, a comparison of projected tax benefits with potential profits would further confirm that the partnership's activities were engaged in for profit.

We also reject respondent's suggestion that because the partnership and its partners could have made more money over the life of the partnership by investing in municipal bonds, the partnership's activities were not engaged in for profit. "[T]he availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit." Sec. 1.183-2(b)(9), Income Tax Regs. It is not for us to second-guess investment decisions by taxpayers.

The record establishes that the partnership engaged in its activities with the predominant purpose and intention of making a profit. It follows that petitioner's deductions of her distributive share of partnership losses and interest expenses are not subject to the limitations of section 183.

Basis

Respondent also argues that petitioner's basis in her partnership interest is limited to her cash contribution to the partnership, and that petitioner therefore is limited to that extent in the amount of her distributive share she can deduct. Again, we disagree.

Section 752(a) provides:

> Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Section 722 provides that a contribution of money by a partner to the partnership increases the partner's basis in the partnership.

Section 752(c) provides:

> For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

Section 1.752-1(e), Income Tax Regs., provides in part:

> A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits. * * *

Petitioner had a 4.94-percent interest in the capital, profits, and losses of the partnership at all relevant times since she became a partner in October of 1977. The partnership's indebtedness was genuine.[20] Petitioner assumed personal liability for her pro rata share (4.94 percent) of the partnership's recourse indebtedness pursuant to the limited partner guarantee, and she was obligated under the limited partnership agreement to make a special contribution to the partnership in an amount not greater than $50,882.[21] Moreover, under the terms of the limited partnership agreement, petitioner had no right to reimbursement from either the partnership or the general partners for amounts paid by her to the partnership as a special contribution or to Sun Life pursuant to the limited partner guarantee.[22] Petitioner was therefore not a mere guarantor of her pro rata share of the partnership's recourse indebtedness, but was ultimately liable for it, because there was no primary obligor against whom she had a remedy to recover amounts paid by her to the partnership as a special contribution or to Sun Life pursuant to the limited partner guarantee. See *Abramson v. Commissioner*, 86 T.C. 360, 366 n. 10 (1986); *Smith v. Commissioner*, 84 T.C. 889, 908 (1985); *Brand v. Commissioner*, 81 T.C. 821, 828 (1983).

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[20] See note 15 *supra* and accompanying text.

[21] Under the terms of the limited partner guarantee and the limited partnership agreement, petitioner was personally liable for the repayment of her pro rata share of the partnership's recourse indebtedness to Sun Life in two ways: first, if the partnership defaulted on its obligation to Sun Life, and if Sun Life brought an action against the partnership to enforce the obligation, petitioner would be required by the partnership, pursuant to sec. 5(c) of the limited partnership agreement, to make her special contribution to the partnership of up to $50,882 (which amount would then be applied by the partnership to the debt owed to Sun Life); in the alternative, if Sun Life chose not to proceed against the partnership for repayment of the debt, Sun Life could proceed directly against petitioner, pursuant to the terms of the limited partner guarantee, and require her to pay up to $50,882, her pro rata share (4.94 percent) of the partnership's recourse indebtedness.

[22] Sec. 6(f) of the limited partnership agreement expressly provided that limited partners had no right to withdraw or reduce their special contributions to the partnership once made, and sec. 7(d) of the limited partnership agreement provided that the general partners were not liable to the limited partners for any loss or liability incurred in connection with any matter, except for losses or liabilities attributable to the willful misconduct or gross negligence of a general partner.

Under these circumstances, section 752 and section 1.752-1(e), Income Tax Regs., entitle petitioner to include in her basis in her partnership interest her allocable share (4.94 percent) of the partnership's recourse and nonrecourse liabilities.[23]

At Risk Issue

Respondent's final contention is that petitioner was not "at risk" within the meaning of section 465 for any amount in excess of her cash contribution to the partnership during any of the years in question. In support of this contention, respondent argues that (1) under the limited partner guarantee, petitioner was a mere guarantor and not ultimately liable for her pro rata share of the partnership's recourse indebtedness, and (2) petitioner was protected against the loss of any amount in excess of her cash contribution to the partnership by the Lloyd's of London insurance policy and Exxon's strong credit rating.[24] For the reasons set forth below, we hold for petitioner on this issue.

Section 465(a) provides that in the case of certain taxpayers engaged in an activity to which section 465 applies, losses from the activity for a taxable year will be allowed up to the aggregate amount that the taxpayer is "at risk" for such activity at the close of such taxable year. Section 465(b)(1) provides that a taxpayer is at risk for money contributed to the activity, and section 465(b)(2) provides that a taxpayer is at risk for amounts borrowed for use in the activity to the extent that the taxpayer is personally liable for the repayment of such amounts. However, section 465(b)(4) provides that "a taxpayer shall not be considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." Petitioner concedes that section 465 applies to her investment in the partnership.

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[23] Respondent argues, however, that in *Brown v. Commissioner*, T.C. Memo. 1980-267, affd. without published opinion 698 F.2d 1228 (9th Cir. 1982), and *Block v. Commissioner*, T.C. Memo. 1980-554, we held that a direct assumption by a limited partner of partnership recourse indebtedness does not entitle the limited partner to increase his basis in his partnership interest. Those cases are distinguishable from this case, however, because neither of them involved, as this case does, a direct assumption by a limited partner of partnership recourse indebtedness coupled with an obligation under the partnership agreement to make additional capital contributions to the partnership.

[24] Respondent also cites some revenue rulings in a footnote in his brief and states simply that the rulings set forth his position regarding recourse notes convertible to nonrecourse notes. It is unclear why respondent cites these rulings. We note that on Jan. 1, 1982, petitioner's personal obligation with respect to the recourse portion of the partnership's indebtedness expired, and that respondent may be suggesting that because of this fact petitioner was not at risk during the years in question for her pro rata share of the partnership's recourse indebtedness. In the absence of such an assertion by respondent, however, we decline to consider this issue.

Petitioner entered into legally enforceable contracts that made her personally liable for her pro rata share of certain partnership indebtedness that was incurred and used by the partnership to acquire the computer equipment. These agreements consist of the limited partner guarantee and the limited partnership agreement, and they were executed by petitioner in October of 1977. Under the limited partner guarantee, petitioner assumed direct liability to Sun Life for her pro rata share of the partnership's recourse indebtedness, and she consented to be sued directly by Sun Life for the portion of the indebtedness she assumed, regardless whether Sun Life first proceeded against the partnership. In the event Sun Life proceeded against the partnership for the recourse indebtedness, however, petitioner was obligated under the limited partnership agreement to make a special contribution to the partnership in an amount sufficient to pay her pro rata share of the indebtedness, and she had no right to reimbursement for any amounts paid by her to Sun Life pursuant to the limited partner guarantee or to the partnership as a special contribution.[25] As a result, contrary to respondent's assertion, petitioner was not a mere guarantor of her pro rata portion of the partnership's recourse indebtedness, but was ultimately liable for it, because there was no primary obligor against whom she had a remedy to recover amounts paid by her to Sun Life pursuant to the limited partner guarantee or to the partnership as a special contribution. See *Abramson v. Commis-*

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[25] See notes 21 & 22 *supra*.

sioner, supra at 366 n. 10; *Smith v. Commissioner, supra* at 908; *Brand v. Commissioner, supra* at 828. Petitioner was therefore at risk within the meaning of section 465 for the full amount of her pro rata share of the partnership's recourse indebtedness to Sun Life. See *Abramson v. Commissioner, supra* at 375-376.[26]

Respondent argues, however, that because Exxon was a strong credit risk and not likely to default on its lease obligations during the years in question, petitioner was protected against loss and was therefore not at risk within the meaning of section 465 for her pro rata share of the partnership's recourse indebtedness. We reject this argument because we perceive nothing in section 465 or its legislative history that requires an owner of property to enter into a transaction with a party that is a poor credit risk in order to be "at risk" within the meaning of section 465.

We also reject respondent's assertion that petitioner was protected against loss by the Lloyd's of London insurance policy. The insured period under the Lloyd's policy did not commence until August 1, 1980, and the policy therefore provided no protection against loss for anyone during the years in question.

Petitioner entered into legally enforceable contracts that made her personally and ultimately liable for her pro rata share of the partnership's recourse indebtedness to Sun Life. The partnership incurred its recourse indebtedness to Sun Life for the purpose of acquiring the computer equipment, and petitioner was not protected against loss with respect to her share of this indebtedness. Consequently, petitioner was at risk within the meaning of section 465 for her proportionate share ($50,882) of the partnership's recourse indebtedness to Sun Life.[27]

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[26] "A limited partner who assumes personal liability on a loan to the partnership (made by a bank or other lender), but who obtains the general partner's agreement to indemnify him against some or all of any loss arising under such personal liability, is at risk only with respect to the excess of the amount of the indebtedness over the maximum amount covered by the indemnity agreement." S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 87 n. 5. It follows that a limited partner such as petitioner, who assumed personal liability on a loan to the partnership, which was made by a bank or other lender, and who had no agreement with anyone to indemnify her against any loss arising with respect to such liability, was at risk for the full amount of the indebtedness. Not only did petitioner not have an agreement with the general partners to indemnify her against loss arising under the limited partner guarantee, but, as already noted, the limited partnership agreement expressly provided that the general partners were not liable to the limited partners for any loss or liability incurred in connection with any matter, except for losses or liabilities attributable to the willful misconduct or gross negligence of a general partner.

We hold that (1) the partnership's transactions were supported by economic substance; (2) the partnership's purchase and lease of the computer equipment were activities that were engaged in for profit; (3) petitioner was entitled to include in her partnership basis her pro rata share of the partnership's recourse and nonrecourse liabilities; and (4) petitioner was "at risk" within the meaning of section 465 for her pro rata share of the partnership's recourse indebtedness. It follows that petitioner is entitled to deduct her distributive share of partnership losses and interest expenses for the years in question.

Decision will be entered under Rule 155.

Appendices to this opinion
follow on pages 1505-1510.

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[27] As a result of petitioner's cash contribution to the partnership and her assumption of her pro rata share of the partnership's recourse indebtedness, petitioner was at risk in the partnership's leasing activity at the close of each of the taxable years in question for an amount sufficient to permit her to deduct all of the claimed losses and interest expenses.

		Dec. 31—	
	1977	*1978*	*1979*
Amount at risk	[1]$75,878.50	[2]$54,986.50	[2]$27,254.50
Claimed losses and interest expenses	20,892.00	27,732.00	11,121.00
Excess amount at risk	54,986.50	27,254.50	16,133.50

[1] Cash contribution of $24,996.50 plus proportionate share of recourse indebtedness, $50,882.

[2] Amount at risk as of end of immediately preceding taxable year, reduced by losses claimed by petitioners with respect to immediately preceding taxable year. See sec. 465(b)(5).

APPENDIX A

DARTMOUTH ASSOCIATES **REMAINING LIMITED PARTNER'S CONTRIBUTION $499,928**

SCHEDULE A

Projections of taxable events are made for informational purposes only, and they have not been passed upon by counsel. The projections do not take into account the effect, if any, of the maximum tax, the minimum tax and the investment interest limitation on the particular circumstances of individual investors. They are based upon the assumptions, and are subject to the risks described in the accompanying memorandum, and must be viewed in light of such assumptions and risks (see particularly the discussions under "Federal Tax Consequences"). No representations or warranties are being made as to tax effect, depreciable lives, methods and allocations, or legal effect of the transaction.

Year	(1) (A) *Rental income*	(2) (B) *Debt service*	(3) *Interest expense*	(4) *Amortization*	(5) (C) *Depreciation*	(6) (D) *Expenses*	(7) *Taxable income (loss)*	(8) *Net cash flow*[1]
1977	277,041	274,656	120,196	154,460	569,729	10,000	(422,884)	365
1978	665,988	664,845	263,661	401,184	963,194	500	(561,367)	640
1979	665,988	664,845	224,938	439,907	665,683	500	(225,133)	640
1980	633,318	625,643	183,239	442,404	604,197	500	(154,619)	640
1981	587,580	586,440	143,185	443,255	604,197	500	(160,303)	640
1982	587,580	586,440	100,400	486,040	302,099	500	184,580	640
1983	587,580	586,440	53,485	532,955		500	533,596	640
1984[2]	342,755	293,222	7,751	285,471		500	334,504	165
Total	4,347,830	4,282,531	1,096,855	3,185,676	3,709,099	13,500	(471,627)	4,370

The amounts in columns (1) - (8) include the general partners' 1.1% allocation and the initial limited partner's .1% allocation for which respective capital contributions of $5,566 and $506 will be made.

[1] The "Net cash-flow" reflects estimated administrative expenses to the partnership of $500 per annum.

[2] 1984 projections do not take into account the effect of the residual value of the equipment upon release or sale at the expiration of the lease.

September 21, 1977

APPENDIX A
(continued)

DARTMOUTH ASSOCIATES
SCHEDULE B

LIMITED PARTNER'S CONTRIBUTION $49,993

Projections of taxable events are made for informational purposes only, and they have not been passed upon by counsel. The projections do not take into account the effect, if any, of the maximum tax, the minimum tax and the investment interest limitation on the particular circumstances of individual investors. They are based upon the assumptions, and are subject to the risks described in the accompanying memorandum, and must be viewed in light of such assumptions and risks (see particularly the discussions under "Federal Tax Consequences"). No representations or warranties are being made as to tax effect, depreciable lives, methods and allocations, or legal effect of the transaction.

	(1)	(2)	(3) (A)	(4) (B)	(5) (C)	(6) (D)	(7) (E)	(8) (F)	(9) (D)	(10) (E)	(11) (F)	
						After tax cash benefit 70% bracket			After tax cash benefit 60% bracket			
Year	*Purchase installment*	*Interest*	*Annual cash outlay*	*Annual taxable profit (loss)*	*Annual cash distribution*	*Annual benefit*	*net benefit*	*Net cumulative*	*Annual benefit*	*net benefit*	*Net cumulative*	*Year*
1977	10,640		10,640	(41,781)	36	29,283	18,643	18,643	25,105	14,465	14,465	1977
1978	21,270	2,755	24,025	(58,218)	63	40,816	16,791	35,434	34,994	10,969	25,434	1978
1979	10,110	1,266	11,376	(23,509)	63	16,519	5,143	40,577	14,168	2,792	28,226	1979
1980	7,973	558	8,531	(15,834)	63	11,147	2,616	43,193	9,563	1,032	29,258	1980
1981				(15,838)	63	11,150	11,150	53,343	9,566	9,566	38,824	1981
1982				18,237	63	(12,703)	(12,703)	41,640	(10,879	(10,879	27,945	1982
1983				52,719	63	(36,840)	(36,840)	4,800	(31,568)	(31,568)	(3,623)	1983
Residual value (G)												
1984 (0)%				30,085	16	(21,044)	(21,044)	(16,244)	(18,035)	(18,035)	(21,658)	
1984 (10 - $358,969)				65,552	35,482	(10,404)	(10,404)	(5,604)	(3,849)	(3,849)	(7,472)	
1984 (16 - 574,351)				86,831	56,762	(4,020)	(4,020)	780	4,663	4,663	1,040	
1984 (25 - 735,887)				102,791	72,722	768	768	5,568	11,047	11,047	7,424	
1984 (30 - 825,630)				111,658	81,589	3,428	3,428	8,228	14,594	14,594	10,971	
1984 (40 - 1,005,114)				129,391	99,322	8,748	8,748	13,548	21,687	21,687	18,064	

Notes

September 21, 1977

(A) The 1977 installment in column (1) is payable in cash upon subscription to a unit of the partnership. The remaining installments represent payments in satisfaction of limitied partners' notes secured by letter of credit. Column (2) is calculated at 7% per annum on the unpaid portion of the limited partners' notes. The installment payments and interest thereon are payable annually. Column (3) equals the sum of limited partners' installment payments (column 1) and interest thereon (column 2).

(B) Column (4) equals a one unit limited partner's 9.88% share of "taxable profit (loss)" of the partnership and interest thereon (column 2).

(C) Column 5 represents annual net cash-flow from operations available for distribution applicable to a one unit share.

(D) Column 6 equals the sum of 70% of "Annual taxable profit (loss)" (column 4) and "Annual cash distribution" (column 5). Column (9) equals the sum of 60% of "Annual taxable profit (loss)" column (4) and "Annual cash distribution" (column 5).

(E) Columns (7 and 10) equal "Annual benefit" (column 6 or 9) less "annual cash outlay" (column 3).

(F) Columns (8 and 11) are the cumulative sums of column (7 or 10) respectively.

(G) The alternative figures for 1984 assume a sale of all of the equipment for different amounts constituting different percentages of the original purchase price.

*Represents a one unit (9.88%) limited partner's share of "taxable profit (loss)" of the partnership (see Schedule A column (7)), adjusted for an assumed sale of all of the equipment (see note (G)), less the balance of a one unit limited partner's capital account ($2,964) at such time.

APPENDIX A
(continued)

DARTMOUTH ASSOCIATES — **LIMITED PARTNER'S CONTRIBUTION $49,993**

SCHEDULE B

Projections of taxable events are made for informational purposes only, and they have not been passed upon by counsel. The projections do not take into account the effect, if any, of the maximum tax, the minimum tax and the investment interest limitation on the particular circumstances of individual investors. They are based upon the assumptions, and are subject to the risks described in the accompanying memorandum, and must be viewed in light of such assumptions and risks (see particularly the discussions under "Federal Tax Consequences"). No representations or warranties are being made as to tax effect, depreciable lives, methods and allocations, or legal effect of the transaction.

Year	(1) *Purchase installment*	(2) *Interest*	(3) (A) *Annual cash outlay*	(4) (B) *Annual taxable profit (loss)*	(5) (C) *Annual cash distribution*	(6) (D) *Annual benefit*	(7) (E) *After tax cash benefit 55% bracket net benefit*	(8) (F) *Net cumulative*	*Year*
1977	10,640		10,640	(41,781)	36	23,016	12,376	12,376	1977
1978	21,270	2,755	24,025	(58,218)	63	32,083	8,058	20,433	1978
1979	10,110	1,266	11,376	(23,509)	63	12,993	1,617	22,050	1979
1980	7,973	558	8,531	(15,834)	63	8,772	241	22,291	1980
1981				(15,838)	63	8,774	8,774	31,065	1981
1982				18,237	63	(9,967)	(9,967)	21,098	1982
1983				52,719	63	(28,932)	(28,932)	(7,835)	1983
Residual value (G)									
1984 (0%)				30,085	16	(16,531)	(16,531)	(24,366)	
1984 (10 - $358,969)				65,552	35,482	(572)	(572)	(8,407)	
1984 (16 - 574,351)				86,831	56,762	(9,005)	9,005	1,170	
1984 (25 - 735,887)				102,791	72,722	16,187	16,187	8,352	
1984 (30 - 825,630)				111,658	81,589	20,177	20,177	12,342	
1984 (40 - 1,005,114)				129,391	99,322	28,157	28,157	20,322	

September 21, 1977

Notes

(A) The 1977 installment in column (1) is payable in cash upon subscription to a unit of the partnership. The remaining installments represent payments in satisfaction of limited partners' notes secured by letter of credit. Column (2) is calculated at 7% per annum on the unpaid portion of the limited partners' notes. The installment payments and interest thereon are payable annually. Column (3) equals the sum of limited partners' installment payments (column 1) and interest thereon (column 2).

(B) Column (4) equals a one unit limited partner's 9.88% share of "taxable profit (loss)" of the partnership and interest thereon (column 2).

(C) Column 5 represents annual net cash-flow from operations available for distribution applicable to a one unit share.

(D) Column 6 equals the sum of 55% of "Annual taxable profit (loss)" (column 4) and "Annual cash distribution" (column 5).

(E) Column (7) equals "Annual benefit" (column 6) less "Annual cash outlay" (column 3).

(F) Column (8) is the cumulative sum of column (7).

(G) The alternative figures for 1984 assume a sale of all of the equipment for different amounts constituting different percentages of the original purchase price.

*Represents a one unit (99.88%) limited partner's share of "taxable profit (loss)" of the partnership (see Schedule A column (7)), adjusted for an assumed sale of all of the equipment (see note (G)), less the balance of a one unit limited partner's capital account ($2,964) at such time.

APPENDIX B

SECURITY AND LOAN AGREEMENT

Dated as of June 15, 1977 * * *

* * * * * * *

5. *Liability of Borrower.* Except as otherwise provided in this Section 5, the Borrower shall have no personal liability hereunder, including without limitation, any liability to pay the principal of or interest on the Loan or any other amount which may at any time be payable to the Lender hereunder, and the Lender agrees to take no action against the Borrower personally except such as may be necessary to subject to the satisfaction of the indebtedness the Borrower's interest in the Equipment, the Leases and any sums due or to become due under the Leases. The Borrower shall, however, be personally liable hereunder, but only to the extent hereinafter set forth (the "At Risk Amount"), in the event that (i) as a result of a default hereunder the Lender forecloses its lien on the Equipment, (ii) the Equipment is sold upon and pursuant to such foreclosure for a gross sale price of less than $975,000 and (iii) the Lender, prior to January 1, 1982, obtains a final deficiency judgment against the Borrower in an amount no greater than the At Risk Amount. The At Risk Amount shall be that amount, if any, by which the sum of $975,000 exceeds the gross sale price, if any, of the Equipment upon such foreclosure sale. In the event of any inconsistency between the foregoing provisions of this Section 5 and any other provision herein contained, the foregoing provisions of this Section 5 shall prevail. Notwithstanding the foregoing, at any time the Lender shall have recourse against the "income and proceeds from the Equipment" and the Lender may look to such income and proceeds to the extent available for distribution to the Lender. As used herein the phrase "income and proceeds from the Equipment" shall mean:

(a) If one of the events of default specified in Section 8 hereof shall have occurred and be continuing and the Lender shall have declared the Loan to be due and payable in accordance with the provisions of Section 8 hereof, so much of the following amounts as are indefeasibly received by the Borrower or the Lender at any time after such event of default and during the continuance of such event of default:

(i) all Rent (as defined in the Lease) and any other sums due or to become due under the Lease (after deducting all reasonable and necessary out-of-pocket costs and expenses of collection thereof actually incurred by the Borrower); and

(ii) any and all payments or proceeds received by the Borrower or the Lender for or with respect to the Equipment under the Lease, or as a result of the sale or other disposition thereof (after deducting all reasonable and necessary out-of-pocket costs and expenses of such sale or other disposition actually incurred by the Borrower); and

(b) at any other time, only that portion of the amounts referred to in clauses (a)(i) and (a)(ii) of this Section 5 as are indefeasibly received by the

Borrower or the Lender and as shall equal all amounts due and payable to the Lender with respect to the Loan.

Subject to the limitation on liability of the Borrower herein contained (including, but not limited to, such limitations as are referred to in clauses (a)(i) and (a)(ii) of this Section 5), the obligation of the Borrower to pay the principal of and interest on the Loan and all other amounts payable to the Lender hereunder shall be fully enforceable (by appropriate proceedings against the Borrower in law or in equity or otherwise) against the Borrower's right, title and interest in the Equipment, its interest in the Lease and the Rent and any other sums due or to become due under the Lease, and nothing contained herein limiting the liability of the Borrower shall derogate from the right of the Lender to enforce, as provided in Section 8 hereof, its security interest in the Collateral for the unpaid principal of and interest on the Loan and all other amounts payable to the Lender hereunder and under the Notes, including, without limitation, the right to accelerate the maturity of payments on the Loan as provided herein upon an event of default hereunder and to proceed against the Lessee or the Lessor under the Leases for any Rent and any other sums due or to become due under the Leases and to realize upon the Equipment.

* * * * * * *

SECURITY AND LOAN AMENDMENT AGREEMENT NO. 1

This Agreement dated as of September 1, 1977 between Sun Life Insurance Company of America (the "Lender") and Dartmouth Associates (the "Borrower").

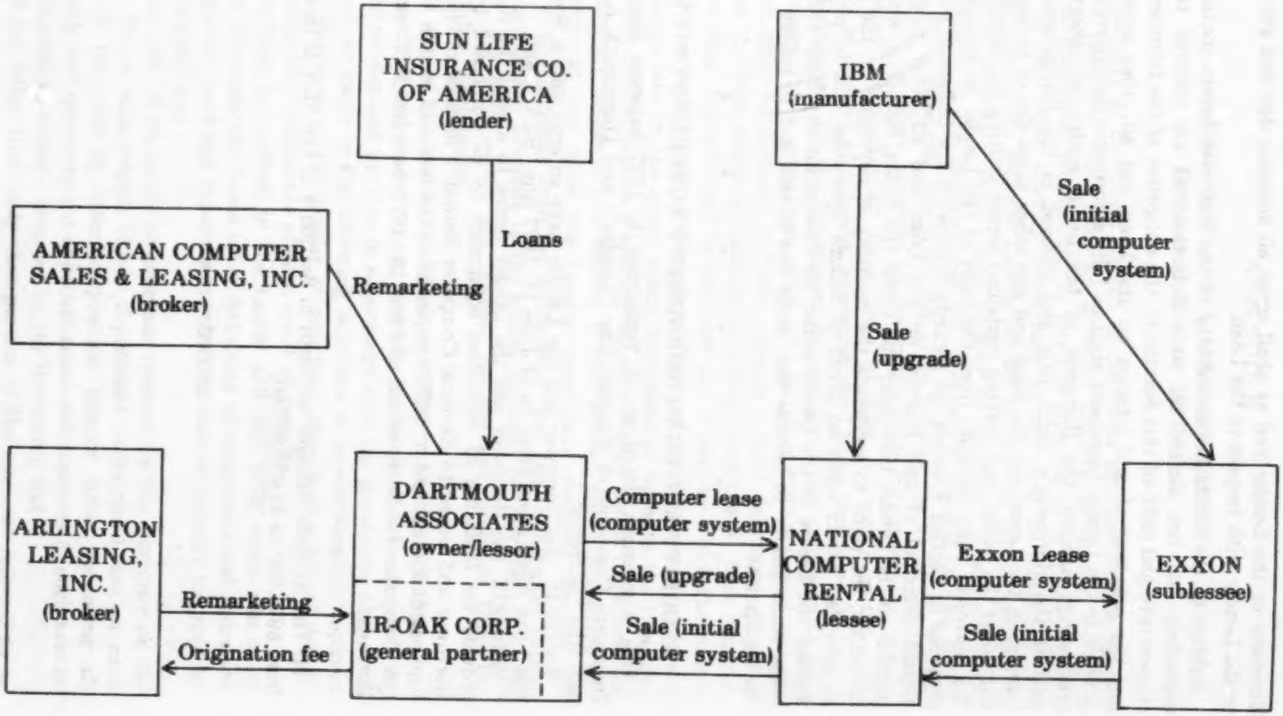
WHEREAS, the Borrower and the Lender have entered into a Security and Loan Agreement dated as of June 15, 1977 (the "SLA"); and

WHEREAS, the Borrower and the Lender desire to amend the SLA to provide for financing of additional equipment to be purchased by the Borrower and leased to National Computer Rental, a division of National Equipment Rental, Ltd. ("NCR") pursuant to the terms of section 18A of the Computer Lease dated as of June 15, 1977 between NCR and the Borrower.

* * * * * * *

(4) The At Risk Amount set forth in Section 5 of the SLA is increased from $975,000 to $1,030,000.00;

APPENDIX C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IBM (manufacturer)
AMERICAN COMPUTER SALES & LEASING, INC. (broker)
Loans
Remarketing
Sale (upgrade)
Sale (initial computer system)
ARLINGTON LEASING, INC. (broker)
Remarketing
Origination fee
DARTMOUTH ASSOCIATES (owner/lessor)
IR-OAK CORP. (general partner)
Computer lease (computer system)
Sale (upgrade)
Sale (initial computer system)
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*U.S. G.P.O. 1987-181-748:40013